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TAX INFORMATION
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CONTENTS

Inland Revenue
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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **www.ird.govt.nz/public-consultation**

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

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Below is a list of recent items out for consultation. You can get copies from **www.ird.govt.nz/public-consultation/** or by emailing **public.consultation@ird.govt.nz**

Ref	Draft type	Title	Comment deadline
PUB00261	Interpretation statement	Taxation of trusts – income tax	27 June 2017
ED0195	General determination	Depreciation rate for potato cool stores	23 June 2017
ED0196	Standard practice statement	Income equalisation deposits and refunds	14 July 2017

IN SUMMARY

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BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

Product Ruling – BR Prd 17/01: Kiwibank Limited

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Kiwibank Limited.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of ss BG 1, CC 7, EW 15, EW 31, RE 1(1) and RF 2(1).

The Arrangement to which this Ruling applies

The Arrangement is a product that Kiwibank intends to offer to its customers. The product is to be marketed as the "Kiwibank Offset Mortgage" (the Product). The Product allows a customer to elect that interest payable by the customer on a loan made by Kiwibank should be calculated by offsetting the balance of the loan against the aggregate credit balances of certain nominated transaction and savings and investments bank accounts (hereafter referred to as "credit accounts") held by either that customer or, certain other eligible persons. Interest is payable on the net notional balance of these combined accounts.

This Ruling does not consider the tax consequences of any arrangement under which a credit account holder agrees to offset his or her credit account balance against another person's home loan account balance in return for valuable consideration.

Further details of the Arrangement are set out below.

Background

1. The Product is a feature that Kiwibank offers to new and existing customers. Kiwibank intends to extend the class of customers who are eligible to utilise the Product. Previously, Kiwibank has only made the Product available to individual customers. It now intends to increase the functionality of the Product in order to make it available to business customers, including companies and trusts.
2. The Product is capable of affecting the way in which interest is calculated on loans offered by Kiwibank which had an agreed fixed periodic repayment arrangement (also referred to as the "table portion" of a loan). Kiwibank also offers loans with a revolving credit feature whereby amounts can be repaid or re-borrowed at any time provided the principal, interest, fees and costs on the loans do not exceed the specified maximum credit limit (also referred to as the "revolving portion" of a loan). The Product does not apply to "revolving portion" loans.
3. In overall commercial terms, the economic consequences for a customer of using the Product, or using a revolving portion loan product bearing a variable interest rate, are broadly the same.
4. Prior to the introduction of the Product, customers of Kiwibank could elect for their table portion loan to have one or more of three components: fixed, variable, and construction components.
5. The "fixed component" of the loan is subject to a fixed interest rate for a fixed term. Customers may repay all or part of a fixed component at any time, although in certain circumstances they may be charged with a fixed rate break cost for making any repayment that exceeds an early repayment limit agreed with Kiwibank.
6. The "variable component" of the loan is subject to a variable interest rate. Customers may repay all or part of a variable component of a loan at any time without any break costs.

7. The "construction component" of the home loan is available where the home loan is obtained for the purpose of buying land and building a house on it or renovating a house on land the borrower already owns. The construction component of the home loan is subject to a variable interest rate and can be borrowed in stages (as opposed to a fixed or variable component which must be borrowed in a lump sum).
8. Kiwibank recognises that customers may have a range of accounts, including various deposit and loan accounts. Therefore, Kiwibank introduced the Product, which included a new component called the "offset variable component".
9. When a customer elects that all or part of a loan is to have an offset variable component, interest accruing on that loan, or that portion of the loan, is to be calculated by reference to a notional balance. The notional balance is calculated by offsetting the debit balance of the offset variable component of the loan against the total credit balances of nominated everyday banking and savings and investments accounts (referred to as the "credit accounts"). This lowers the interest payable and the variable component of the loan. Therefore, it results in a greater proportion of a customer's regular loan repayments being applied in reduction of the principal of the offset variable component of the loan.
10. This new feature effectively treats a group of accounts in a collective or aggregated manner for the purposes of calculating interest accrued on the offset variable component of the loan. This feature is intended to make the Kiwibank overall banking relationship more attractive to current and potential customers.

Interest calculations

Calculations of interest on an offset variable component of a loan

11. Interest payable on an offset variable component of the nominated loan is calculated by reference to a notional balance. This notional balance is determined, for the purposes of that calculation only, by reducing the balance of the offset variable component of the loan by the aggregate of the credit balances of the nominated credit accounts.
12. The rate of interest applicable to the Product is the "offset variable interest rate". The offset variable interest rate is one of a number of different rates which Kiwibank uses, under the Terms and Conditions of the various loans to which the Product applies. The offset variable interest rate may be above or below Kiwibank's variable interest rate.
13. Interest is not calculated separately in respect of each account and then offset. Instead, a net notional balance is calculated across all the relevant accounts. The notional balance equals the offset variable component of the loan less (ie, "offset" against) the credit balances of the nominated credit accounts. Interest is then payable on that net balance at the offset variable interest rate. This is the case as a matter of law (in terms of the terms of contractual relationship under the various Terms and Conditions applicable to eligible loans offered by Kiwibank) and as a matter of practice (in terms of Kiwibank's computer and accounting systems).
14. The offsetting is solely for the purpose of calculating the notional balance on which interest is calculated. There is no actual transfer of funds, no set-off or "netting" of funds together in an account, and no transfer of any interest in or entitlement to funds. Importantly, the customer has no legal entitlement to interest on credit balances. This is the case even if the customer's total credit balances exceed the customer's loan balance.
15. Interest is calculated on a daily basis and is debited to the loan account on a regular basis. Loan repayments are credited periodically into the loan accounts, which will pay the periodic interest and reduce the principal outstanding. Such payments are made from a Kiwibank account that the customer has selected. This account may or may not be another credit account that the customer has nominated to participate in the Product.
16. The offsetting aspect of the Product essentially offers the same economic benefits to customers as a revolving portion loan in terms of reduced interest costs (through a reduced balance on which interest is calculated) and consequently will accelerate loan repayments. With a revolving portion loan, funds that would otherwise be in a savings or cheque account are paid into the loan account (but are available to be redrawn).
17. Under the updated terms and conditions of the Product, Kiwibank intends to make the Product available to business customers for the first time. However, business customers will not have the ability to group their accounts with accounts of another entity, as individuals can.

No interest is payable on credit accounts

18. Under the terms and conditions agreed between Kiwibank and its customers for this Product, no interest is payable by Kiwibank on the credit balances of the credit accounts that customers have nominated to participate in the Product. This is regardless of whether those credit balances exceed the debit balance of the loan facility. This means that if the debit balance of a loan facility is less than the aggregate of the credit balances of the nominated credit accounts, no interest is paid or payable by Kiwibank.

Eligibility requirements

19. The product is only available to:
    - An individual who holds an eligible loan with Kiwibank;
    - Two individuals who are married, in a civil union, or in a de facto relationship and who hold an eligible loan with Kiwibank;
    - A company which holds an eligible loan with Kiwibank (under the proposed changes to the product); and
    - A trust which holds an eligible loan with Kiwibank (under the proposed changes to the product).
20. "Eligible loans" will be the following loan products currently offered by Kiwibank:
    - Business loans secured by residential property; and
    - Home loans.
21. The following additional persons can elect to "offset" their Kiwibank credit account against the loan of an individual customer or two individual customers who are married, in a civil union, or in a de facto relationship:
    (a) a child or children of the customer (or one of the customers); or
    (b) a parent or parents of the customer (or one of the customers).
22. Children and parents of individual customers can have a registered address with Kiwibank that is different from that of the customer's.
23. An offset variable component of a loan can be "offset" against nominated accounts of the customer(s) or other eligible persons (in the case of individual customers).

Other features of an offset variable component

24. The offset variable component is not an independent product; it is a component of a loan. The following features (amongst others) apply to the offset variable component along with the other components of a table portion loan:
    - Interest is calculated on a daily basis, and is debited to the loan account on each specific payment date.
    - Customers may repay all or part of an offset variable component of a loan at any time without any break costs, other than a flat administration fee.
    - The interest and principal of an offset variable component are repayable by way of regular payment cycles over the term of the offset variable component, except in relation to any applicable interest-only period. Only interest payments are required to be made during an interest only period. "Repayment holidays" are also available, where no interest or principal is payable during a specific period.
    - All amounts owing under the table portion (including any offset variable component and other components) must be repaid in full on the last day of the loan term.
    - The offset variable interest rate can vary at any time. Kiwibank will give the customer notice before changing the rate:
      - If the offset variable interest rate increases, the customer's regular payments for the offset variable component will automatically increase if this is necessary to enable the customer to pay off the offset variable component over the agreed term.
      - If the offset variable interest rate decreases, the customer's regular payments for the offset variable component will remain the same, so the term of the loan will shorten. However, the customer can elect to reduce the amount of the regular payment so that the offset variable component can be repaid over the same term.
    - The Product is offered to customers having an existing variable rate table portion loan facility. If an existing customer elects to convert a part or all of an existing variable rate table portion loan to have an offset variable component, the customer must agree that Kiwibank's applicable terms and conditions for the Product will apply. All new customers will sign new terms and conditions applicable to all Kiwibank accounts, which will, by definition, include the terms and conditions applicable to the Product.
    - A customer may have more than one loan account to which the terms and conditions of the Product apply, but each such loan account is treated separately. In the case of individual customers only, they may group their loan and credit accounts with the credit accounts of certain other individuals.

- A transaction or deposit account (eg, everyday banking, savings and investments accounts) may be nominated to link to one or more loan accounts under the Product terms and conditions. If the outstanding balance of the various loan accounts exceeds the balance of the deposit account, the order of offsetting is determined by the "priority" ranking of each loan, as designated by the customer.
- Interest cannot be capitalised on any loan to which the Product applies, except to the extent of any interest component on a defaulted payment which may be "capitalised" only for the purpose of calculating further interest and default interest owing on the loan. The defaulted interest does not become part of the outstanding principal loan balance and will remain an outstanding interest payment.

Terms and conditions for the Product

25. Each Kiwibank loan is documented under a collection of documents:

    a) In respect of home loans:

        i) The Home Loan Terms and Conditions, which are contained in a booklet that Kiwibank issues (as amended and updated from time to time) and which set out the generic provisions applicable to all Kiwibank home loan facilities.

        ii) The Home Loan Agreement, which contains specific provisions about the home loan facility that is being made available to a specific customer, including the amount and timing of regular payments calculated on a basis that will repay the loan over the applicable term.

    b) In respect of other loans:

        i) The Lending Terms and Conditions for Business and Rural Banking – effective December 2012, which set out the generic provisions applicable to all of Kiwibank's business lending facilities.

        (ii) The Loan Agreement, which contains particular and specific provisions in relation to the business loan facility that is being made available to a specific customer including the amount and timing of regular payments, calculated on a basis which will repay the loan over the applicable term.

    c) In respect of all loans:

        i) The General Terms and Conditions, that contains the terms that govern the general banking relationship between Kiwibank and its customers. The General Terms and Conditions may also contain specific terms and conditions that apply to particular accounts and services.

        - In the event that there is any conflict between any part of the General Terms and Conditions and the Home Loan Terms and Conditions, the Home Loan Terms and Conditions will apply.
        - In the event that there is any conflict between any part of the General Terms and Conditions and the Lending Terms and Conditions for Business and Rural Banking, the Lending Terms and Conditions for Business and Rural Banking apply.

Groups of accounts

26. The product is based on a group of participating accounts. The following rules explain which accounts can be included in the group:

    (a) The accounts of an individual, or the individual and joint accounts of married, de facto and civil union couples, any of their children, and any of their parents may be combined as part of one group.

    To illustrate, Sarah and Peter have a home loan facility with Kiwibank. If Sarah and Peter and their child, Michael, each have a savings account with Kiwibank, the home loan facility could be offset by the credit balances of the various accounts held by them.

    (b) Borrowers of the home loan facility and owner of other transaction accounts nominated for the "offset" feature must be either:

        (i) all residents of New Zealand for tax purposes; or

        (ii) all non-residents of New Zealand for tax purposes.

    (c) Companies, trusts and sole traders are eligible to participate in the product Companies, trusts, and sole traders may group their transaction and eligible loan accounts for the purposes of the product. However, a company, trust, or sole trader may not group their accounts with the accounts of any other individual or entity.

Condition stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) All interest rates related to the Product are arm's length market interest rates.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the condition stated above, the Taxation Laws apply to the Arrangement as follows:

a) No consideration is paid, or payable, by virtue of the offset feature of the Product for the purposes of calculating income and expenditure under ss EW 15 or EW 31.

b) No income arises under s CC 7 for Kiwibank's customers in relation to the Arrangement.

c) For the purposes of the "resident withholding tax rules" (as defined in s RE 1(1)) and the "non-resident withholding tax rules" (as defined in s RF 1(1)), there is no payment of, or entitlement to, interest in relation to the credit accounts participating under the Arrangement, that would give rise to an obligation to deduct resident withholding tax or non-resident withholding tax or pay an approved issuer levy.

d) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 June 2016 and ending on 31 May 2021.

This Ruling is signed by me on the 6th day of March 2017.

Howard Davis
Director (Taxpayer Rulings)

Public Ruling - BR Pub 17/04 and 17/05: Income tax – treatment of alteration to rights attached to shares under section CB 4

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling is about how s CB 4 applies to the Arrangement.

The Arrangement to which this Ruling applies

The Arrangement is where a shareholder holds shares in a company and the shares were acquired for the purpose of disposal. Subsequently, the rights attached to the shares are altered and the following apply:

- The shares are in a company registered under the Companies Act 1993.
- The alteration is not structured as a cancellation and issue of shares.

For the avoidance of doubt, the Arrangement does not include an arrangement where s BG 1 applies to void the arrangement.

How the taxation law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- The alteration of rights attached to the shares does not result in a disposal of personal property for the purposes of s CB 4.

The period or tax year for which this Ruling applies

This Ruling will apply for the period 1 April 2017 to 31 March 2020.

This Ruling is signed by me on 18 April 2017.

Susan Price
Director, Public Rulings

Public Ruling BR PUB 17/05: Income tax – treatment of a disposal of shares with altered rights under section CB 4

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation law

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling is about how s CB 4 applies to the Arrangement.

The Arrangement to which this Ruling applies

The Arrangement is where a shareholder holds shares in a company and the shares were acquired for the purpose of disposal. Subsequently, the rights attached to the shares are altered and the following apply:

- The shares are in a company registered under the Companies Act 1993.
- The alteration is not structured as a cancellation and issue of shares.
- After the alteration, the shareholder disposes of some or all of their shares with altered rights.

For the avoidance of doubt, the Arrangement does not include an arrangement where s BG 1 applies to void the arrangement.

How the taxation law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Section CB 4 applies to the disposal of shares with altered rights.
- The time of acquisition of a share with altered rights held on revenue account is the time the share was acquired before the alteration.

The period or tax year for which this Ruling applies

This Ruling will apply for the period 1 April 2017 to 31 March 2020.

This Ruling is signed by me on 18 April 2017.

Susan Price
Director, Public Rulings

Commentary on Public Ruling BR Pub 17/04 and BR Pub 17/05

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Rulings BR Pub 17/04 and BR Pub 17/05 ("the Rulings").

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

Summary

1. The Rulings consider two situations. The situations represent two points in time at which s CB 4 could apply when share rights are altered, namely when the:
    - rights are altered; and
    - shares with altered rights are disposed of.
2. Whether s CB 4 applies in these situations depends on whether the shares with altered rights are the same property as the shares before the alteration.
3. A basis sometimes put forward for shares with fundamentally altered rights being different property is the contractual doctrine of rescission. In the case of alterations provided for in the terms on which the shares were issued, the alteration would be pursuant to the original contract, so the contractual doctrine of rescission would not apply. For the contractual doctrine of rescission to be relevant in other cases, there must be a contract. This makes the nature of a share, and whether

share rights are conferred by contract, relevant in determining whether shares with altered rights are the same property as the shares before the alteration. It is also relevant to consider the rules in the Companies Act 1993 (CA 1993) for the issue and cancellation of shares and the altering of share rights.

4. The Commissioner considers that shares with altered rights are the same property as the shares before the alteration for the purposes of s CB 4 for four reasons:
   - The rights and obligations comprising a share are not conferred by contract, so the contractual doctrine of rescission is not relevant.
   - Based on the rules in the CA 1993 for the issue and cancellation of shares and the altering of share rights, there is no cancellation and issue of shares by implication when share rights alter.
   - When share rights alter, at no point does a shareholder lose control of their shares and have only a right to receive shares, such as may be the case when shares are cancelled and new shares are issued.
   - Altering share rights does not involve property moving from the company to the shareholders. The alteration merely alters the shareholders' existing rights against the company.
5. Accordingly, the alteration of rights attached to shares (share rights) does not result in a disposal of any shares for the purposes of s CB 4. The shares continue in existence with altered rights. The Commissioner considers that this will be the case whether there is a minor change, or a complete change of class.
6. When a shareholder who acquired the shares on revenue account before the alteration disposes of the shares after the alteration, s CB 4 will apply to the disposal. This is because the shares with altered rights are the same property as the shares before the alteration. Therefore, the time of acquisition of the shares with altered rights is the time the shares were acquired before the alteration.
7. While an alteration of share rights will not result in a disposal of a share, it may have an effect on shareholder continuity.
8. If a change in the rights attached to a share is effected by cancelling the old share and issuing a new share, there will be a disposal for the purposes of s CB 4 when the share is cancelled.

Background

9. Shares confer rights on shareholders: s 36(1) of the CA 1993. The rights can be altered by the constitution of the company, if any, or the terms on which the shares were issued: s 36(2) of the CA 1993. Altering share rights may be referred to as alterations, share reclassifications or share reorganisations.
10. Section CB 4 provides that an amount derived from the disposal of personal property acquired for the purpose of disposal is income of the person. Shares are a type of personal property: s 35 of the CA 1993. Questions arise as to the application of s CB 4 where share rights alter and when a shareholder disposes of shares with altered rights.

Application of the legislation

11. Under s CB 4, an amount that a person derives from disposing of personal property is income of the person if they acquired the property for the purpose of disposing of it:

    CB 4 Personal property acquired for purpose of disposal

    An amount that a person derives from disposing of personal property is income of the person if they acquired the property for the purpose of disposing of it.

12. The Rulings consider two points in time at which s CB 4 could apply when share rights are altered, namely when the:
    - rights are altered;
    - shares with altered rights are disposed of.
13. Whether s CB 4 applies in these situations depends on whether the shares with altered rights are the same property as the shares before the alteration.

Can the shares with altered rights be regarded as the same property as the shares before the alteration?

14. Two broad requirements of s CB 4 must be satisfied. If these requirements are met, an amount that the person derives from disposing of the personal property is income of the person. The first requirement is that a person acquires personal property for the purpose of disposing of it. The second requirement is that the person disposes of the personal property.
15. The grammatical construction of s CB 4 shows that the property disposed of must be the same property as that acquired.

BINDING RULINGS

When share rights alter, the question arises whether the shares are the same property as the shares before the alteration. The answer to this question will also assist in determining the time of acquisition of the shares with altered rights for the purposes of s CB 4. In determining whether the shares with altered rights are the same property as the shares before the alteration, it is helpful to ask two questions:

- What is the nature of a share?
- Are shares disposed of when rights attached to them alter?

What is the nature of a share?

16. Section 36 of the CA 1993 sets out the basic rights and powers that attach to shares. The basic rights and powers include the right for the shareholder to vote at a meeting of the company on any resolution, the right to an equal share in dividends authorised by the board, and the right to an equal share in the distribution of surplus assets of the company.

17. A company may issue different classes of shares: s 37(2) of the CA 1993. "Class" means a class of shares having identical rights, privileges, limitations and conditions attached to them: s 116(1) of the CA 1993.

18. It is generally accepted that a share is a bundle of rights and obligations between the shareholders and the company: *Borland's Trustee v Steel Brothers & Co Ltd* [1901] 1 Ch 279; *Bradbury v English Sewing Cotton Ltd* [1923] AC 744 (HL); *IR Commrs v Laird Group plc* [2003] UKHL 54. This was confirmed by the New Zealand Court of Appeal in *Robertson v Bicknell* [2002] BCL 408 (CA). In *Robertson* at [23], the Court also confirmed that the nature of the property in a share is the interest of a person in the company, that interest comprising various rights and obligations.

19. A shareholder does not have a proprietary right or interest in the assets of a company. A shareholder has been said to be entitled to a proportion of the company's share capital, with reference to which the shareholder has certain rights: *Archibald Howie v Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 at 156.

20. The property comprising a share encompasses all of the rights and obligations attached to the share. A shareholder does not own each share right as a separate piece of property: *In re Alex Russell (deceased)* [1968] VR 285 at 299.

21. Previously, under the Companies Act 1955 (CA 1955), the memorandum and articles of a company were deemed to be a contract between the company and its shareholders: s 34 of the CA 1955. However, the CA 1993 replaced the contractual model in the CA 1955: *Maori Development Corp Ltd v Power Beat International Ltd* [1995] 2 NZLR 568 (HC). The relationship between a company and its shareholders is now statutory: ss 31 and 38 of the CA 1993.

22. Obiter dicta in some cases decided under the CA 1993 suggest the relationship between a company and its shareholders is a contractual one: *Ord v Calan Healthcare Properties Ltd* [2004] 2 NZLR 122 (HC); *Todd Petroleum Mining Co Ltd v Shell (Petroleum Mining) Co Ltd* (2005) 2 NZCCLR 266 (HC); *Herzog v Hertli* (HC Blenheim CIV-2007-406-251, 23 March 2009); *Manak v Hutt & City Taxis Ltd* [2009] NZCCLR 36 (HC). However, in *Maori Development Corp*, s 31 of the CA 1993 was specifically referred to and considered. Blanchard J said, at 574, that the contractual model in the CA 1955 had been replaced by the statutory statement in s 31 of the CA 1993.

23. Blanchard J's view is supported by statements made by the New Zealand Law Commission on the form and content of a new Companies Act in *Company Law Reform and Restatement* (NZLC R9, New Zealand Law Commission, Wellington, June 1989). In that report, at 1, the Commission said that one of the most significant proposed reforms was to redefine "the distribution of power within the company by direct operation of statute rather than by a deemed contract". The Commission said, at 19, that "[t]he standard constitution, and any modification of it, should confer rights directly and not, as the [CA 1955] provides, by deeming the constitutional documents to be a contract". Also, the Explanatory Note to the Companies Bill introduced on 21 September 1990 stated, at ii, that a purpose of the Bill was to redefine "the distribution of power within the company by direct operation of statute rather than by a deemed contract".

24. The change from the contractual model of the CA 1955 is important. This is because under the contractual model, fundamentally altering the share rights may have amounted to rescission of a contract and the entering into of a new one and, by implication, a cancellation of the shares and the issue of new ones. This would not have been the case, though, if the alteration arose from the terms of the shares themselves or the articles of association of the company (or constitution in the case of the CA 1993). However, given the statutory basis of shares under the CA 1993, the contractual doctrine of rescission is not relevant. Whether the shares are cancelled and new ones are issued depends on the operation of the CA 1993 and the company's constitution, if any.

25. The Commissioner considers that the relationship between a company and its shareholders is statutory. The Commissioner has previously considered the nature of shares: "Commentary on Public Ruling BR Pub 16/05 and BR Pub 16/06", *Tax Information Bulletin* Vol 28, No 5 (June 2016): 5, "Income tax – Treatment of a subdivision of shares under section CB 4:

Public Ruling – BR PUB 16/05", *Tax Information Bulletin* Vol 28, No 5 (June 2016): 3, and "Income tax – Treatment of a disposal of subdivided shares: Public Ruling – BR PUB 16/06", *Tax Information Bulletin* Vol 28, No 5 (June 2016): 4. The commentary on BR Pub 16/05 and BR Pub 16/06 states that it is generally accepted that a share is a bundle of rights and obligations conferred under a contract between the shareholders and the company. To the extent that the commentary on BR Pub 16/05 and BR Pub 16/06 suggests the relationship between a company and its shareholders is contractual, it is incorrect. The commentary to these Public Rulings (BR Pub 17/04 and BR Pub 17/05) should be relied on as setting out the Commissioner's view on the nature of a share and the relationship between a company and its shareholders.

Are shares disposed of when the rights attached to them alter?

26. "Dispose" is not defined in s YA 1 for the purposes of s CB 4. (It is defined for the purposes of other sections in the Act, but these definitions do not assist in this inquiry.) The courts have held that, speaking generally, "disposed of" covers all forms of alienation and carries connotations of sale, assignment, or transfer of the property: *FCT v Wade* (1951) 84 CLR 105 (HCA); *Lyttelton Port Co Ltd v CIR* (1996) 17 NZTC 12,556 (HC). "Disposition" has been said to mean "a ridding oneself of the right or interest": *Coles Myer Ltd v Commissioner of State Revenue (VIC)* (1998) ATC 4,537 (VICCA) at 4,456. As a result, the Commissioner considers that "disposing" of property must involve the alienation or ridding of that property by the disposer.

27. If there is a cancellation and issue of shares by implication when share rights alter, then that would indicate that shares have been disposed of and that the shares with altered rights are different property from the shares before the alteration.

28. The CA 1993 provides comprehensive rules for the issue and cancellation of shares, and the altering of share rights.

29. Section 36 of the CA 1993 provides that the rights and powers attached to shares may be negated, altered or added to by the constitution of the company or in accordance with the terms on which the share are issued. A company is not required to have a constitution, although it may adopt one by special resolution: ss 26 and 32 of the CA 1993. If a company does not have a constitution, the company, its board and each of its directors and shareholders have the rights, powers, duties and obligations set out in the CA 1993: s 28 of the CA 1993. If a company does not have a constitution, the rights attached to its shares can alter only in accordance with the terms on which the shares were issued.

30. Sections 117 and 118 of the CA 1993 provide certain rules regarding the alteration of shareholder rights. Section 117(1) of the CA 1993 provides that a company must not take action that affects share rights unless that action has been approved by shareholders whose rights are affected. Section 118 of the CA 1993 gives dissenting shareholders the right to require the company to purchase their shares.

31. The issue of shares is dealt with in ss 41–51 of the CA 1993. The issue of shares has been described as the whole process whereby unissued shares are applied for, allotted and, finally, registered: *National Westminster Bank plc v IRC* [1994] 2 BCLC 239 (HL).

32. Section 42 of the CA 1993 provides that, subject to the CA 1993 and the constitution of the company, if any, a company may issue shares at any time, to any person and in any number it thinks fit. On the face of it, this is a very broad power. However, the right to issue shares is subject to requirements in other provisions of the CA 1993, such as the registration of notice of a share issue and the obtaining of shareholder approval in certain circumstances: ss 43 and 44 of the CA 1993. Section 107(2) of the CA 1993 provides that shares may be issued otherwise than in accordance with some of these requirements, if all entitled persons agree or concur. Section 51 provides that a share is issued when the name of the holder is entered on the share register.

33. Sections 58–67 of the CA 1993 deal with the acquisition by a company of its own shares and their deemed cancellation. Section 59 provides that a company may acquire its own shares if permitted by its constitution, if any. Generally, any shares so acquired are deemed to be cancelled immediately on acquisition. A company must comply with procedural requirements when acquiring its own shares, such as meeting a solvency test and registration of notice of the acquisition: ss 58 and 59 of the CA 1993.

34. Sections 68–75 of the CA 1993 deal with the redemption of shares and their deemed cancellation. Section 68 provides that shares are redeemable if:
    - the constitution of the company makes provision for the issue of redeemable shares, and
    - the constitution or the terms of issue of the shares makes provision for the redemption of the shares for a consideration that is specified or calculated by a formula or suitably qualified person.

35. Shares a company redeems are deemed cancelled immediately on redemption. A company must comply with procedural requirements when redeeming shares, such as board resolutions and meeting a solvency test in certain circumstances: ss 69 and 70 of the CA 1993.

36. The rules in the CA 1993 for the issue and cancellation of shares, and the altering of share rights, make it seem unlikely that an alteration of share rights by the company's constitution, if any, or the terms on which the shares are issued could involve the cancellation and issue of shares by implication.

37. Further, s 83 of the CA 1993 provides for a statement of rights to be given to shareholders, on request. Section 83(2) provides that the company does not have to provide a shareholder with such a statement in certain circumstances, including if a statement has been provided within the previous six months and the:

- shareholder has not acquired or disposed of shares since the previous statement was provided (s 83(2)(b) of the CA 1993); and
- the rights attached to shares of the company have not been altered since the previous statement was provided (s 83(2)(c) of the CA 1993).

38. The relevance of s 83(2) of the CA 1993 is the distinction that Parliament has drawn between the acquisition of shares and the alteration of share rights. It is apparent from s 83(2) of the CA 1993 that Parliament regarded the acquisition of shares and the alteration to share rights as different things.

39. Based on the rules in the CA 1993 for the issue and cancellation of shares and the altering of share rights, the Commissioner considers that there is no cancellation and issue of shares by implication when share rights alter. This will be the case whether there is a minor change, or a complete change of class.

40. There are also other indications that shares are not disposed of when share rights alter. One such indication is that when share rights alter there is no point at which a shareholder loses control of their shares and has only a right to receive shares, such as may be the case when shares are cancelled and new shares are issued.

41. Another is that altering share rights does not involve property moving from the company to the shareholders. The alteration merely alters the shareholders' existing rights against the company: *Robertson v FCT* (1952) 86 CLR 463.

Conclusion

42. The Commissioner considers that shares with altered rights are the same property as the shares before the alteration for the purposes of s CB 4 for four reasons:

- The rights and obligations comprising a share are not conferred by contract, so that the contractual doctrine of rescission is not relevant.
- Based on the rules in the CA 1993 for the issue and cancellation of shares and the altering of share rights, there is no cancellation and issue of shares by implication when share rights alter.
- When share rights alter there is no point at which a shareholder loses control of their shares and has only a right to receive shares, such as may be the case when shares are cancelled and new shares are issued.
- Altering share rights does not involve property moving from the company to the shareholders. The alteration merely alters the shareholders' existing rights against the company.

43. This conclusion is consistent with IS9708 "Available subscribed capital – Consequences of deemed reregistration" (*Tax Information Bulletin* Vol 10, No 7 (July 1998): 8 which considers the consequences of share reclassifications on available subscribed capital.

44. While the altered shares will be the same property, it is noted that any change to the voting rights (defined in s YC 2) attached to shares may affect shareholder continuity for the purposes of determining whether losses and imputation credits can be carried forward. It is also noted that s GB 34 (ICA arrangements for carrying amounts forward) may apply in some circumstances if voting rights are altered.

Does s CB 4 apply at the time share rights are altered?

45. When share rights alter, the Commissioner considers that the shareholder does not alienate, rid themselves of, or otherwise lose control of their shares. Shares with altered rights are the same property as the shares before the alteration. Given this, the Commissioner considers s CB 4 does not apply at the time share rights are altered.

Does s CB 4 apply at the time shares with altered rights are disposed of?

46. An amount derived by a person on the disposal of shares with altered rights, where the shares were acquired for the purpose of disposal before the alteration, will be income of the person under s CB 4. Conversely, s CB 4 will not apply to an amount derived by a person on the disposal of the shares where the shares were not acquired before the alteration for the purpose of disposal. This is because the shares held by the person after rights attached to the shares have been altered are the same property as the shares held by the person before the alteration.

What is the time of acquisition for shares with altered rights held on revenue account?

47. Given that the shares with altered rights are the same property as the shares before the alteration, the Commissioner considers that the time of acquisition of the shares with altered rights is the time the shares were acquired before the alteration.

Examples

48. The following examples are included to help explain the application of the law.

Example 1 — shares acquired for the purpose of disposal

49. On 15 May 2015, Shani purchased 1,000 shares in Red Packaging Ltd (RPL) for $10 per share. Shani acquired the shares for the purpose of disposing of them. Therefore, Shani holds these shares on revenue account.

50. The directors of RPL decide to create a new class of share with preferential rights to dividends and limited voting rights. The rights attached to half of RPL's issued shares will be altered to create the new class of share. Five hundred of Shani's shares will have their rights altered and become part of the new class of shares. The alteration has been approved by interested shareholders.

51. The alteration occurs on 30 July 2016. Shani's shares are not formally cancelled or redeemed; nor are any new shares issued. Section CB 4 will not apply at this time because Shani has not disposed of anything.

52. On 15 August 2016, Shani sells all of her shares in RPL for $15,000. At this point, the requirements of s CB 4 have been met. Shani has derived an amount from the disposal of property that she acquired for the purpose of disposal. As a result, Shani will have derived income on the sale of the shares. Shani's net income from the sale of the shares in RPL will be $5,000.

Example 2 — shares not acquired for purpose of disposal

53. On 10 April 2012, Blue Ltd purchased 100 shares in Orange Transport Ltd (OTL) as a long-term investment. The shares carry preferential rights to dividends and have limited voting rights. The directors of OTL propose that the rights attached to the shares be altered on 1 June 2013 so as to attract ordinary rights to dividends and full voting rights. Blue Ltd is among the majority of shareholders who vote in favour of the alteration. The shares are not formally cancelled or redeemed; nor are any new shares issued. Section CB 4 will not apply on 1 June 2013 when the share rights alter because Blue Ltd has not disposed of anything.

54. On 1 October 2013, due to a change in investment strategy, Blue Ltd decides to sell its shares in OTL. Section CB 4 will not apply to the amount that Blue Ltd derives on the disposal of its shares in OTL. This is because, even though Blue Ltd voted in favour of the alteration to share rights, the shares with altered rights are the same property as the shares before the alteration. When Blue Ltd acquired the shares on 10 April 2012, it did not have a purpose of disposing of them.

References

Subject references

Alteration of rights attached to shares
Disposal
Issue and cancellation of shares
Personal property
Shares

Legislative references

Companies Act 1955, s 34
Companies Act 1993, ss 26, 28, 31, 32, 35–38, 41–51, 58–75, 83, 107, 116–119
Income Tax Act 2007, s CB 4

Case references

Alex Russell (deceased), In re [1968] VR 285
Archibald Howie v Commissioner of Stamp Duties (NSW) (1948) 77 CLR 143
Borland's Trustee v Steel Brothers & Co Ltd [1901] 1 Ch 279
Bradbury v English Sewing Cotton Ltd [1923] AC 744 (HL)
Coles Myer Ltd v Commissioner of State Revenue (VIC) (1998) ATC 4,537 (VICCA)
FCT v Wade (1951) 84 CLR 105 (HCA)
Herzog v Hertli (HC Blenheim CIV-2007-406-251, 23 March 2009)
IR Commrs v Laird Group plc [2003] UKHL 54
Lyttelton Port Co Ltd v CIR (1996) 17 NZTC 12,556 (HC)
Manak v Hutt & City Taxis Ltd [2009] NZCCLR 36 (HC)
Maori Development Corp Ltd v Power Beat International Ltd [1995] 2 NZLR 568 (HC)
National Westminster Bank plc v IRC [1994] 2 BCLC 239 (HL)
Ord v Calan Healthcare Properties Ltd [2004] 2 NZLR 122 (HC)
Robertson v Bicknell [2002] BCL 408 (CA)
Robertson v FCT (1952) 86 CLR 463
Todd Petroleum Mining Co Ltd v Shell (Petroleum Mining) Co Ltd (2005) 2 NZCCLR 266 (HC)

Other references

"Commentary on Public Ruling BR Pub 16/05 and BR Pub 16/06", *Tax Information Bulletin* Vol 28, No 5 (June 2016): 5
Company Law Reform and Restatement (NZLC R9, New Zealand Law Commission, Wellington, 1989)
"Income tax – Treatment of a subdivision of shares under section CB 4: Public Ruling – BR PUB 16/05", *Tax Information Bulletin* Vol 28, No 5 (June 2016): 3
"Income tax – Treatment of a disposal of subdivided shares: Public Ruling – BR PUB 16/06", *Tax Information Bulletin* Vol 28, No 5 (June 2016): 4

Public Ruling - BR Pub 17/06: Fringe benefit tax - charitable and other donee organisations and fringe benefit tax

Note (not part of the Ruling):

This Ruling replaces "Public Ruling BR Pub 09/03: Charitable Organisations and Fringe Benefit Tax", *Tax Information Bulletin* Vol 21, No 6 (August 2009): 12, which has been withdrawn from 30 June 2017. Under s 91DE of the Tax Administration Act 1994, BR Pub 09/03 will continue to bind the Commissioner for arrangements entered into before 1 July 2017 for a further three years. This Ruling will apply to arrangements entered into on or after 1 July 2017.

Organisations qualifying for the FBT exclusion may choose whether to apply this Ruling to their existing arrangements, but after three years this Ruling will apply to all arrangements providing fringe benefits, regardless of when they are entered into.

If there is an existing arrangement and the provision of a fringe benefit changes, then this Ruling will apply to the changed arrangement.

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of s CX 25.

The Arrangement to which this Ruling applies

The Arrangement is the provision of a non-monetary benefit by a charitable or other donee organisation, not being a local authority, public authority or university, (the qualifying organisation) to an employee of that organisation.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Where a short-term charge card facility (as defined in s CX 25(3)) is provided to an employee of a qualifying organisation and the value of that benefit for the employee in a tax year is more than the lesser of 5% of the employee's salary or wages or $1,200, that benefit is a fringe benefit and the exclusion in s CX 25(1) does not apply.
- Where any other non-monetary benefit is provided to an employee of a qualifying organisation:
  - A fringe benefit **is not** provided where the benefit is not received mainly in connection with their employment.
  - A fringe benefit **is not** provided where the benefit is received mainly in connection with their employment to the extent that:
    - the employee is employed in carrying out the qualifying organisation's benevolent, charitable, cultural or philanthropic purposes; or
    - the employee is employed in a business carried on by the qualifying organisation, where the business activity is within (ie, carries out) the organisation's benevolent, charitable, cultural or philanthropic purposes.
  - A fringe benefit **is** provided where the benefit is received mainly in connection with the employee's employment, to the extent that the employee is employed in a business carried on by the qualifying organisation, where the business activity is outside (ie, does not carry out) the organisation's benevolent, charitable, cultural, or philanthropic purposes, regardless of whether business profits are applied to the organisation's benevolent, charitable, cultural or philanthropic purposes.

The period or tax year for which this Ruling applies

This Ruling will apply for a period of five years beginning on 1 July 2017.

This Ruling is signed by me on 28 April 2017.

Susan Price
Director, Public Rulings

Commentary on Public Ruling BR Pub 17/06

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 17/06 (the Ruling).

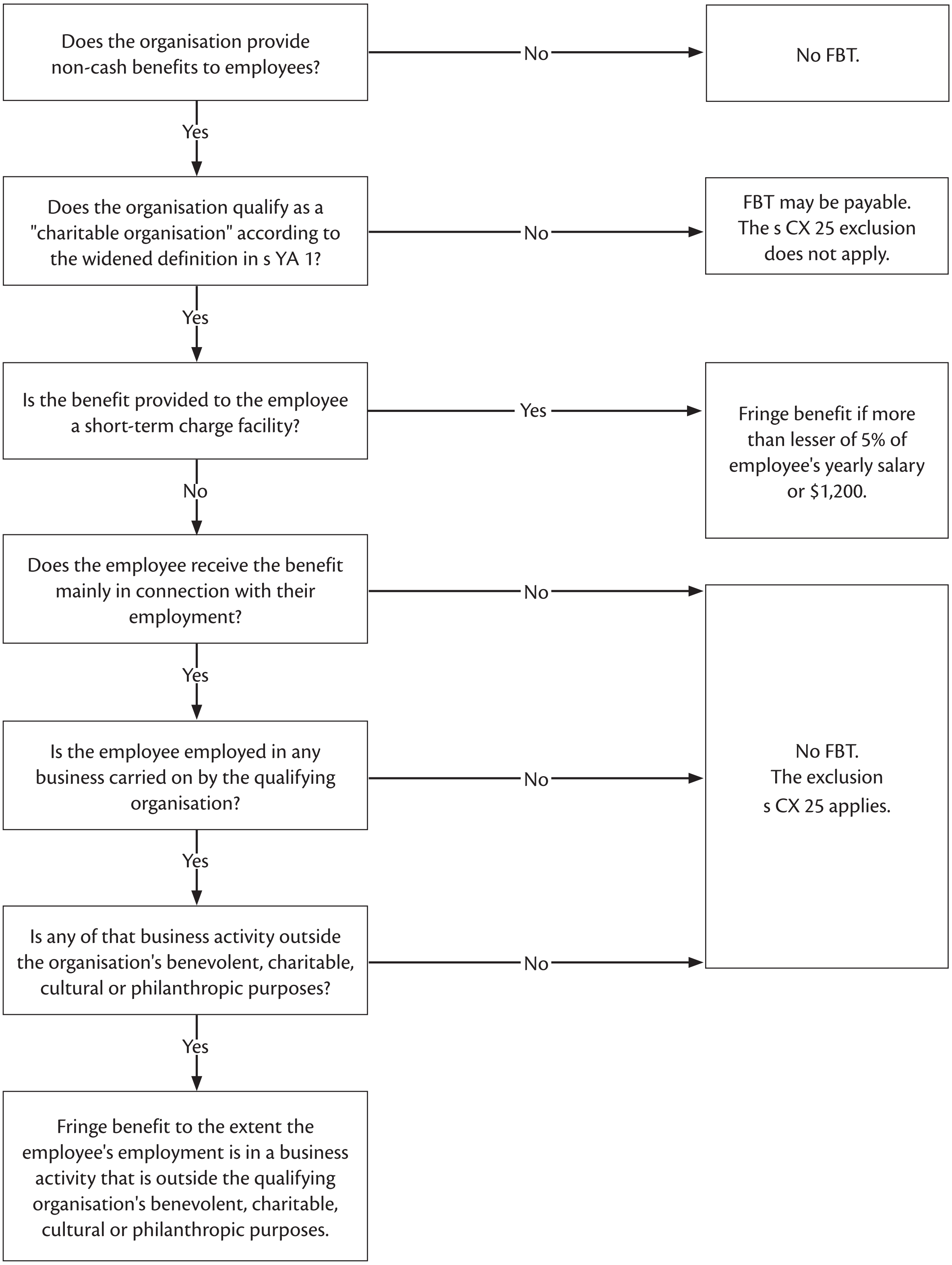
Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

Summary

1. Section CX 25 excludes some benefits provided to employees by qualifying non-profit organisations from being fringe benefits for fringe benefit tax (FBT) purposes. This Ruling and commentary explains which organisations the FBT exclusion applies to and how it applies.
2. The exclusion in s CX 25 applies to "charitable organisations". This term is defined in s YA 1 and, in the FBT context, has a wider meaning than simply organisations that can be registered under the Charities Act 2005. It includes most organisations usually referred to as "donee organisations"; that is, any associations, funds, institutions, organisations, societies or trusts that are not carried on for the private pecuniary profit of an individual and whose funds are applied wholly or mainly to benevolent, charitable, philanthropic or cultural purposes. Local authorities, public authorities and universities are specifically excluded from being "charitable organisations" for FBT purposes (and therefore the ordinary FBT rules apply to them). For ease of reference, in this commentary the types of non-profit organisations that can rely on the FBT exclusion in s CX 25 are referred to as "qualifying organisations".
3. Qualifying organisations carry on a variety of activities. Those activities may include business activities. Those business activities may be within the organisation's benevolent, charitable, cultural or philanthropic purposes or outside those purposes – even if undertaken to help fund the organisation's benevolent, charitable, cultural or philanthropic purposes.
4. Essentially, the FBT exclusion in s CX 25 applies where a qualifying organisation provides a benefit to an employee mainly in connection with their employment, in an activity carried on *within* the organisation's benevolent, charitable, cultural or philanthropic purposes.
5. The exclusion does **not** apply where a qualifying organisation provides a benefit to an employee mainly in connection with their employment, to the extent the benefit is provided in a business activity carried on *outside* the qualifying organisation's benevolent, charitable, cultural or philanthropic purposes.
6. The exclusion also does **not** apply to benefits provided by a qualifying organisation to an employee by way of short-term charge facilities (ie, credit or charge cards), if the value of those benefits in a tax year exceeds the lesser of 5% of the employee's salary or wages for the tax year or $1,200.

7. The following flowchart summarises the approach to take to decide whether the exclusion in s CX 25 applies:

Exclusion from FBT for qualifying organisations



Background

8. This Ruling replaces "Public Ruling BR Pub 09/03: Charitable Organisations and Fringe Benefit Tax", *Tax Information Bulletin* Vol 21, No 6 (August 2009): 12 (the previous ruling). BR Pub 09/03 was withdrawn from 30 June 2017. It was a reissue of "Charitable Organisations and Fringe Benefit Tax (FBT): Public Ruling BR Pub 00/08", *Tax Information Bulletin* Vol 12, No 9 (September 2000): 3.

9. BR Pub 09/03 was withdrawn because the Commissioner's view on aspects of that ruling has changed. BR Pub 09/03 was published for an indefinite period. Therefore, on withdrawal, the Commissioner continues to be bound by it for arrangements entered into before the withdrawal date for a further three years (see s 91DE(4A) of the Tax Administration Act 1994).

10. This Ruling applies to any arrangements entered into on or after 1 July 2017. This Ruling also applies to arrangements previously covered by BR Pub 09/03 where the provision of the benefit changes in some way, so that a new arrangement is created.

Approach taken to analysis

11. The approach taken in this commentary is to:
    - briefly consider the legislative context of the FBT exclusion in s CX 25;
    - identify types of organisations that may qualify for the FBT exclusion;
    - address the following issues arising from the exception to the FBT exclusion (as set out in s CX 25(1)(a) and (b)):
        - when a benefit received by an employee is mainly in connection with their employment
        - when a qualifying organisation's activity is a business
        - when a qualifying organisation's business activity is within its charitable purposes;
    - discuss whether s CX 25(1) contemplates apportionment; and
    - consider briefly the rules regarding credit cards and charge cards provided to employees of a qualifying organisation.

Legislative context of the FBT exclusion

12. Under the Act, an employer may be liable to pay FBT on fringe benefits that it provides to an employee. "Fringe benefit" is defined in s CX 2(1) as follows:

    Meaning

    (1) A **fringe benefit** is a benefit that—

    (a) is provided by an employer to an employee in connection with their employment; and

    (b) either—

    (i) arises in a way described in any of sections CX 6, CX 9, CX 10, or CX 12 to CX 16; or

    (ii) is an unclassified benefit; and

    (c) is not a benefit excluded from being a fringe benefit by any provision of this subpart.

13. This definition is broad and intended to include all non-cash payments an employer makes to an employee in connection with their employment.

14. Section CX 25(1) excludes benefits provided by certain qualifying organisations to their employees from being fringe benefits, except in certain circumstances (see s CX 25(1)(a) and (b)):

    CX 25 Benefits provided by charitable organisations

    When not fringe benefit

    (1) A charitable organisation that provides a benefit to an employee does not provide a fringe benefit except to the extent to which—

    (a) the employee receives the benefit mainly in connection with their employment; and

    (b) the employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes.

15. Section CX 25(2) and (3) also limits the exclusion in s CX 25(1) by providing that the exclusion does not apply to benefits provided to an employee by way of short-term charge facilities if the value of those benefits in a tax year is more than the lesser of 5% of the employee's salary or wages for the tax year or $1,200.

Applying the legislation

16. For a benefit to be a fringe benefit, it must be provided by an employer to an employee in connection with their employment and must not be excluded from being a fringe benefit by one of the exclusions in subpart CX (see s CX 2 Meaning of fringe benefit). Where the employer is a qualifying organisation, a benefit provided to an employee is excluded from being a fringe benefit by s CX 25(1), except in certain circumstances. This means that, to the extent the exclusion in s CX 25 applies, no FBT is payable on the benefit provided to the employee by the qualifying organisation.

What types of organisations qualify for the FBT exclusion in s CX 25?

17. The FBT exclusion in s CX 25 applies to a wider category of organisations than simply organisations that can be registered under the Charities Act 2005.

18. The term "charitable organisation" is defined in s YA 1 for the purposes of the FBT exclusion:

charitable organisation —

(a) means, for a quarter or an income year, **an association, fund, institution, organisation, society, or trust to which section LD 3(2) (Meaning of charitable or other public benefit gift) or schedule 32 (Recipients of charitable or other public benefit gifts)** applies—

(i) in the quarter; or

(ii) in the income year, if fringe benefit tax is payable on an income year basis under section RD 60 (Close company option); and

(ab) **includes a person who has been removed from the register of charitable entities** (the **register**) under the Charities Act 2005, but only for the period starting on the day the person is registered on the register and ending on the earlier of the last day of the following periods:

(i) the quarter, or income year if section RD 60 (Close company option) applies, in which the person does not comply with their rules contained in the register:

(ii) the quarter, or income year if section RD 60 applies, in which the day of final decision falls; and

(b) **does not include a local authority, a public authority, or a university.**

[Emphasis added.]

19. The definition of "charitable organisation" essentially relies on the description of a "donee organisation" set out in the tax credit rules for charitable or other public benefit gifts. However, it specifically does not include local authorities, public authorities or universities.

20. The tax credit rules for charitable or other public benefit gifts provide a description of the types of organisation to be treated as a "donee organisation" for gifting purposes in s LD 3(2):

Description of organisations

(2) The following are the entities referred to in subsection (1)(a) and (b):

(a) a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic, or cultural purposes within New Zealand:

(ab) an entity that, but for this paragraph, no longer meets the requirements of this subsection, but only for the period starting on the day it fails to meet those requirements and ending on the later of—

(i) the day the entity is removed from the register of charitable entities under the Charities Act 2005:

(ii) the day on which all reasonably contemplated administrative appeals and Court proceedings, including appeal rights, are finalised or exhausted in relation to the person's charitable status.

(ac) a community housing entity, if the gift is made in a tax year that the entity meets the requirements to derive exempt income under section CW 42B (Community housing trusts and companies):

(b) a public institution maintained exclusively for any 1 or more of the purposes within New Zealand set out in paragraph (a):

(bb) a Board of Trustees that is constituted under Part 9 of the Education Act 1989 and is not carried on for the private pecuniary profit of any individual:

(bc) a tertiary education institution:

(c) a fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a), by a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual:

(d) a public fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a).

21. Organisations of the types described in s LD 3(2) essentially include associations, funds, institutions, organisations, societies or trusts that:

- are not carried on for the personal gain of an individual; and
- apply their funds wholly or mainly to charitable, benevolent, philanthropic or cultural purposes within New Zealand.

22. The definition of "charitable organisation" also includes organisations listed in schedule 32. Schedule 32 lists certain named organisations that Parliament has approved as being "recipients of charitable or other public benefit gifts". These are often international charities with a New Zealand presence, which would not otherwise qualify as "donee organisations" as they do not apply their funds wholly or mainly **within** New Zealand.

23. Therefore, the FBT exclusion in s CX 25 applies to organisations of the types described in s LD 3(2) or listed in sch 32, which together are referred to as "donee organisations" in s YA 1. The FBT exclusion does not apply to local authorities, public authorities or universities.

Exception to the FBT exclusion

24. Generally, qualifying organisations are not subject to FBT. However, there are two exceptions. The first exception is where the benefits provided are certain types of short-term charge facilities (discussed at [62]). The second exception is where benefits are provided mainly in connection with employment to employees who work for businesses outside the organisation's purposes. This second exception is set out in s CX 25(1) and has two limbs, paras (a) and (b):

CX 25 Benefits provided by charitable organisations

When not fringe benefit

(1) A charitable organisation that provides a benefit to an employee does not provide a fringe benefit except to the extent to which—

(a) the employee receives the benefit mainly in connection with their employment; and

(b) the employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes.

25. The first limb of the exception in s CX 25(1) considers whether a benefit is received by the employee mainly in connection with their employment. The second limb looks at the activities being carried on by a qualifying organisation in which the employee is engaged.

When is a benefit received by an employee mainly in connection with their employment?

26. The first limb of the exception (s CX 25(1)(a)) requires the employee to receive the benefit mainly in connection with their employment.

27. In the Commissioner's view, this wording recognises that a qualifying organisation may provide benefits to people who are acting in different capacities for the organisation. It is not unusual for people to be employed by the organisation in a particular role and for those same people to also provide additional or different services to the organisation, for example, on a voluntary (unpaid) basis.

28. In the Commissioner's view, the purpose of the wording in s CX 25(1)(a) is to clarify that a potential liability for FBT will arise only where an employee receives a benefit from a qualifying organisation mainly in their employment capacity and not in some other capacity (eg, in their voluntary capacity).

29. The word "mainly" is used in s CX 25 as a result of the rewrite of the Income Tax Act. The intended meaning of "mainly" in the rewritten Act is discussed in *Tax Information Bulletin* Vol 16, No 5 (June 2004) (at p 71):

Mainly

The rewritten provisions use "mainly" in place of "primarily and principally" and similar expressions. The expression "primarily and principally" was considered by Eichelbaum J in *Newman Tours Ltd v CIR* (1989) 11 NZTC 6,027 (High Court). The judge interpreted the expression as requiring that the purpose not only be the main one, in the sense of outweighing all the other purposes, singly or collectively, but also the primary one - that is, the first one. Sufficiently similar connotations can be conveyed in the single word "mainly".

30. Therefore, a benefit will be provided to an employee of a charitable organisation **mainly** in connection with their employment if the benefit arises primarily in connection with their employment. If an employee is only employed by a charitable organisation, and does no voluntary work, then any benefits provided to that employee will be provided in connection with their employment. But, if, for example, an employee is both employed by and works as a volunteer for a charitable organisation, it will be necessary to determine in which capacity the benefit primarily arises.

31. If a benefit arises equally in connection with both their capacities, the benefit will be provided mainly in connection with the capacity in which the employee is predominantly engaged.

When is a qualifying organisation's activity a business?

32. Under the second limb of the exception (s CX 25(1)(b)), the FBT exclusion in s CX 25(1) does not apply to the extent that a benefit is provided to an employee whose:

employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes.

33. Therefore, the next issue to be considered when deciding whether the FBT exclusion in s CX 25(1) applies is whether the employee is employed in the carrying on by the qualifying organisation of a business. "Business" is defined in s YA 1 as including:

> any profession, trade, or undertaking carried on for profit:

34. The Court of Appeal in *Grieve v CIR* (1984) 6 NZTC 61,682 considered that underlying the use of the word "business" in the context of a taxation statute is the fundamental notion of the exercise of an activity in an organised and coherent way that is directed to an end result – the making of pecuniary profits. The Court found that determining whether a taxpayer is in business involves a two-fold inquiry as to the nature of the activities carried on and the intention of the taxpayer in engaging in those activities. Richardson J (at 61,691) identified several factors relevant to determining whether a taxpayer is carrying on a business, namely the:
    - nature of the activity;
    - period over which the taxpayer engages in that activity;
    - scale of operations and the volume of transactions;
    - commitment of time, money and effort;
    - pattern of the activity; and
    - financial results.
35. Richardson J went on to note that it may also be helpful to consider whether the operations involved are of the same kind and are carried on in the same way, as those that are characteristic of ordinary trade in the line of business in which the venture is conducted. However, in the end, it is the *character* and *circumstances* of the *particular venture* that are crucial.
36. Many charitable or other donee organisations engage in activities on a continuous and ongoing basis, commit time, money and effort to those activities, and conduct a large volume of transactions, with the intention of making a surplus. Such organisations that carry on this type of activity are carrying on a business, as that term is defined in s YA 1.
37. A charitable or other donee organisation carrying on a business (eg, a private school operated by a charitable trust) may still qualify for the FBT exclusion even though it makes a profit. Just because an organisation carries on some activities for profit does not prevent the organisation from being a qualifying organisation for FBT purposes, so long as the activity is not being carried on for the personal gain of an individual. This view is consistent with one of the key descriptions of a "donee organisation" in s LD 3(2)(a):

> a society, institution, association, organisation, or trust that is **not carried on for the private pecuniary profit of an individual,** and whose **funds are applied wholly or mainly to charitable, benevolent, philanthropic, or cultural purposes** within New Zealand. [Emphasis added]

When is a qualifying organisation's business activity within its benevolent, charitable, cultural or philanthropic purposes?

38. If it is established that a qualifying organisation is providing benefits to an employee employed in a business they are carrying on, then the FBT exclusion will still apply to the extent that business activity is being carried on *within* the organisation's benevolent, charitable, cultural, or philanthropic purposes. However, the FBT exclusion will not apply to the extent the employee is engaged in a business activity that is *outside* the qualifying organisation's benevolent, charitable, cultural or philanthropic purposes. Section CX 25(1)(b) provides:

> employment consists of the carrying on by the organisation of a business **whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes**. [Emphasis added]

39. The distinction between business activities that are within, or outside of, the qualifying organisation's benevolent, charitable, cultural, or philanthropic purposes is specific to the FBT exclusion. This is not a distinction that is relevant for income taxation purposes, or when determining whether an organisation is a charitable entity for the purposes of the Charities Act 2005.
40. Applying the second limb of the exception requires an understanding of the types of activities the qualifying organisation is carrying on. Sometimes activities will be within a qualifying organisation's benevolent, charitable, cultural or philanthropic purposes and sometimes activities will be outside those purposes.
41. The distinction between activities carried on within a qualifying organisation's benevolent, charitable, cultural or philanthropic purposes and outside those purposes was discussed in *Trustees of the Dean Leigh Temperance Canteen v Commissioners of Inland Revenue* (1958) 38 TC 315. The High Court of Justice (Chancery Division) considered whether a charity could carry on a business activity that was within its charitable purposes. This was in the context of determining

whether income derived by the trustees was exempt from tax. In the United Kingdom at that time, income from a business was exempt from tax if that business was carried on in the course of carrying out a primary purpose of the charity.

42. The trust was established for the purpose of promoting temperance. It operated a canteen selling non-alcoholic drinks and light refreshments at normal market prices in a market place. The canteen made considerable profits. The issue before the court was essentially whether the canteen activity was a business exercised in the course of carrying out the primary purpose of the charity. The court concluded that the object of the trust was to promote temperance and "the canteen was the engine in their hand for that purpose" (at 325). In other words, the canteen activity was a business activity within (and not outside) the trust's charitable purposes. Accordingly, the income derived from the canteen business was exempt from tax.

43. Another case that considers the distinction between activities carried on by a charity is *Oxfam v City of Birmingham District Council* [1975] 2 All ER 289 (HL). In *Oxfam*, the House of Lords found that where a charity carried out its charitable objects or directly facilitated the carrying out of the charitable objects (such as administrative or clerical activities), it was acting within its charitable purposes. However, where a charity carried on a trading activity that did not carry out its charitable objects, that activity would be outside the charity's charitable purposes. This is the case even if all funds raised from the activity are applied to the charity's charitable purposes.

44. The House of Lords was considering whether Oxfam's gift shops were on premises wholly or mainly used for charitable purposes. The court found that, although the gift shops were used for purposes indirectly related to the achievement of the objects of the charity (ie, selling donated goods to raise money for the charity), the premises were not wholly or mainly used for charitable purposes.

45. In reaching this conclusion, the House of Lords drew a line between the use of premises for purposes that are the charity's charitable purposes and the use of premises for purposes that, though purposes of the charity, are not charitable purposes. Lord Cross said at 293:

> The wording of s 40(1) of the [General Rate Act 1967] shows that the legislature did not consider that the mere fact that the hereditament in question is occupied by a charity justifies any relief from rates. That is only justified if the hereditament is being used for 'charitable purposes' of the charity. So the first question which arises is: what are 'charitable purposes' of a charity as distinct from its other purposes? The answer must be, I think, those purposes or objects the pursuit of which make it a charity — that is to say in this case the relief of poverty, suffering and distress.

46. As well as "those purposes or objects the pursuit of which make it a charity", Lord Cross recognised that activities that are "wholly ancillary to" or "directly facilitate" the carrying out of an organisation's charitable objects will be part of fulfilling the organisation's charitable objects. Fundraising through the gift shops did not meet those criteria.

47. In the Commissioner's view, these cases support the view that activities (including business activities) undertaken to carry out the benevolent, charitable, cultural or philanthropic objects of a qualifying organisation or directly facilitating the carrying out of those objects (including administrative or clerical activities) will be within the benevolent, charitable, cultural or philanthropic purposes of the organisation for the purposes of s CX 25. However, trading activities carried on to raise funds for the organisation that do not in themselves carry out the charitable purposes of the organisation will not be within the benevolent, charitable, cultural or philanthropic purposes of a qualifying organisation for the purposes of s CX 25. This is the case even if all the funds raised from the activity are applied to the qualifying organisation's purpose.

48. Therefore, the Commissioner considers activities will be carried on *within* a qualifying organisation's purposes when they:

- are the performance of a qualifying organisation's benevolent, charitable, cultural or philanthropic purposes; or
- directly facilitate the carrying out of a qualifying organisation's benevolent, charitable, cultural or philanthropic purposes.

49. Activities the Commissioner considers will usually be characterised as being carried on *within* a qualifying organisation's purposes include:

- the carrying out of the qualifying organisation's purposes;
- appeals for funds for the qualifying organisation's purpose;
- passive investment and management of the qualifying organisation's funds, so long as the organisation does not carry on a business of fund investment; and
- the administration of the above activities.

50. On the other hand, business activities that are carried on to raise funds for the qualifying organisation and that are not of themselves achieving a qualifying organisation's benevolent, charitable, cultural or philanthropic purposes, or which do not directly facilitate those purposes, will be treated as business activities outside the purposes of a qualifying organisation. This is the case even if the profits from such business activities are used to fund the qualifying organisation and thereby help it carry out its benevolent, charitable, cultural or philanthropic purposes. For example, a clothing thrift shop run by an animal welfare organisation is a business activity that is *outside* the organisation's object of caring for animals.

51. Applying this approach to s CX 25(1), where benefits are received mainly in connection with employment, to the extent an employee is engaged in activities carrying out a charitable organisation's benevolent, charitable, cultural or philanthropic purposes (including the carrying on of a business activity), benefits provided to them will not attract FBT. However, to the extent a qualifying organisation's employee is engaged in business activities of the organisation that are not of themselves benevolent, charitable, cultural or philanthropic, any benefits provided to the employee will not fall within the exclusion provided by s CX 25, and so may attract FBT.

52. It will be a question of fact in each case whether the business activities of a qualifying organisation are activities that are not of themselves achieving the organisation's benevolent, charitable, cultural or philanthropic purposes. It is, therefore, possible that two qualifying organisations may carry out similar business activities, with different FBT consequences for each organisation. An example of this is where a qualifying organisation operates retail stores selling goods with a view to making a profit. This type of activity would generally be considered to be outside an organisation's benevolent, charitable, cultural or philanthropic purposes, although for some organisations such an activity might fall within their purposes. For example, if the operation of a particular retail store served the purpose of creating job opportunities for a group that the organisation was established to assist, or if the goods were provided at low cost to a group the organisation was established to assist. This business activity may be considered to be achieving the organisation's benevolent, charitable, cultural or philanthropic purposes.

Whether s CX 25(1) contemplates apportionment

53. Just as a person may work for a qualifying organisation in different capacities (eg, as a volunteer or as an employee), an employee may also be employed by a qualifying organisation in different activities, some of which may be within the organisation's benevolent, charitable, cultural or philanthropic purposes and some of which may be outside those purposes.

54. Section CX 25(1) provides that:

> (1) A charitable organisation that provides a benefit to an employee does not provide a fringe benefit except **to the extent to which**—
>
> (a) the employee receives the benefit mainly in connection with their employment; **and**
>
> (b) the employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes.

[Emphasis added]

55. In the Commissioner's view, the phrase "to the extent to which" in s CX 25(1) applies to both paras (a) and (b), but in para (a) it is qualified by the word "mainly". The word "and" between the paragraphs indicates that both paragraphs (ie, both the first and second limbs of the exception) need to be satisfied for the exclusion not to apply.

56. The word "extent" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, 2011) as meaning:

> n. **1** the area covered by something. The size or scale of something. **2** the degree to which something is the case: everyone has to compromise to some extent

57. The Court of Appeal in *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 held that the phrase "to the extent to which" expressly contemplates apportionment. On this point, Richardson J stated in *Buckley & Young* at 61,274:

> The second feature of sec. 111 is that the **statutory language contained in the phrase "to the extent to which" expressly contemplates apportionment**. In *Banks* this Court said, in relation to this aspect of deductibility (p. 61,241):
>
> > "A deduction is allowed to the extent that the statutory standard of deductibility is met. Furthermore, this is not restricted to expenditure which can be dissected with distinct and severable parts being directly referable to the production of assessable income. It extends to outgoings not capable of such dissection but which serve both income earning and other purposes indifferently (*Ronpibon Tin N.L. & Tongkah Compound N.L. v F.C. of T.* (1949) 78 C.L.R. 47."
>
> While sec. 112(a) does not expressly provide in the same way for apportionment between capital and revenue, **at the same time it does not provide to the contrary, for example, by the use of the familiar qualification in taxation legislation "wholly and exclusively"**. Section 112(a) operates as a restriction on deductibility and, as a matter of construction, applies only in so far as the expenditure is of a capital character. In *The Texas Company (Australasia) Limited v F.C. of T.* (1940) 63 C.L.R. 382, 466 referring to the then counterpart of sec. 112(a) Dixon J. said:
>
> > "There is I think nothing which prevents the division or apportionment between capital and income of an outgoing which is in part of a capital nature and in part of a revenue nature."
>
> In our view the same approach is to be made whether the apportionment is under sec. 111 or between capital and revenue expenditure [Emphasis added]

58. In *Banks*, Richardson J also made the observation at 61,243– 61,244 that "[i]ndeed, the expressions 'to the extent' and 'so far as' demonstrate the absence of a statutory minimum applicable in all cases".

59. Richardson J makes it clear that the phrase "to the extent to which" expressly contemplates apportionment. Richardson J does, however, acknowledge that the phrase may not have this meaning if it is qualified with a term like "wholly and exclusively". Therefore, applying that reasoning to s CX 25(1), the word "mainly" in s CX 25(1)(a) could be read as qualifying the phrase "to the extent to which". However, in the Commissioner's view, in s CX 25(1)(a) the word "mainly" places the focus on establishing the principal reason for the employee receiving the benefit. For example, whether the employee received the benefit mainly in connection with their employment or mainly in connection with their role as a volunteer. If it is mainly received in connection with volunteer service, the benefit is not a fringe benefit. However, if the benefit is provided mainly in connection with employment (ie, s CX 25(1)(a) is satisfied) then any volunteer service is disregarded for the purposes of s CX 25(1)(b). This is because only employment is considered for the purposes of applying the second limb of the exclusion in s CX 25(1)(b).

60. Unlike in s CX 25(1)(a), there are no words in s CX 25(1)(b) to qualify the phrase "to the extent to which". This means that, for the purposes of s CX 25(1)(b), the words "to the extent to which" should be given their ordinary meaning (ie, requiring apportionment). Therefore, under s CX 25(1)(b) a qualifying organisation will be subject to FBT only **to the extent to which** that benefit is provided to an employee in connection to their employment in a business activity that is outside the organisation's benevolent, charitable, cultural or philanthropic purposes.

61. In summary, the Commissioner considers FBT will apply only to benefits provided to an employee **mainly in connection with their employment**, and then only **to the extent to which** those benefits are received in connection with **employment in a business carried on outside** a qualifying organisation's purposes. Where an employee is employed in different activities across a qualifying organisation and one or more of those activities is a business activity outside the organisation's purposes, the benefits provided need to be apportioned so only the benefits relating to the employment in the business activity carried on outside the organisation's benevolent, charitable, cultural or philanthropic purposes are treated as fringe benefits. In the Commissioner's view, any apportionment should be reasonable and reflect the reality of the situation. Example 4 provides an example of a reasonable apportionment basis, based on working hours.

Short–term charge facilities

62. As previously stated, the FBT exclusion in s CX 25(1) does not apply to the provision of short-term charge facilities (ie, credit and charge cards) in specified circumstances. Section CX 25(2) states that the exclusion in s CX 25(1) does not apply, and a fringe benefit is provided when a qualifying organisation provides a benefit to an employee by way of a short-term charge facility and the value of the benefit is more than the lesser of 5% of the employee's salary and wages for a tax year and $1,200. Subsection (3) defines the term "short-term charge facility". These types of benefits provided to a qualifying organisation's employees are subject to FBT regardless of whether the employee works in any business. Example 6 at [75] illustrates this point.

Examples

Example 1 – Private school operated by a charitable organisation

63. A non-profit organisation has the principal purpose of providing education through a private school. The organisation is a charitable organisation for the purposes of the FBT rules because it is not carried on for the private gain of any individual and its funds are applied wholly or mainly for the advancement of education within New Zealand.

64. The organisation charges tuition fees for the education it provides and has had surpluses of income over expenditure for the last three income years. It provides a car to its school principal for work and private use.

65. The organisation is not liable for FBT on the benefit arising from the private use or availability for the private use of the car provided to the principal. This is because the benefit is provided by a charitable organisation to an employee who is employed in an activity that is within the charitable organisation's benevolent, charitable, cultural or philanthropic purposes. The employee is not employed in a business activity that is carried on by the charitable organisation outside its benevolent, charitable, cultural or philanthropic purposes.

Example 2 – Farming activity within private school

66. The organisation from Example 1 also conducts a farming business on land adjacent to the school. The farming operation is carried on as a business and it directly facilitates the practical component of the school's agricultural courses. The organisation provides a car to its farm manager for work and private use.

67. The organisation is not liable for FBT on the benefit arising from the private use or availability for private use of the car provided to the farm manager. This is because the farm manager is employed by the charitable organisation to carry out

BINDING RULINGS

its benevolent, charitable, cultural or philanthropic purposes (ie, the advancement of education). In this case, the carrying on of the farming business falls within the benevolent, charitable, cultural or philanthropic purposes of the organisation because of it's direct relationship with the school's agricultural curriculum.

Example 3 – Farming activity outside private school

68. This example has the same facts as in Example 2, except the farming business does not directly facilitate the education of the students at the school. Any profits earned are put back into the school. However, the farm is not used to educate students at the school.

69. In this situation, the organisation is liable for FBT on the benefit arising from the private use or availability for private use of the car provided to the farm manager. This is because the farm manager is employed in a business activity that falls outside the benevolent, charitable, cultural or philanthropic purposes of the organisation. This remains the case despite the fact the profit made from the farming activity is put back into the school.

Example 4 – Employee in food bank and shop

70. A charitable organisation has the principal purpose of relieving poverty by running a food bank. The organisation is a charitable organisation for the purposes of the FBT rules because it is not carried on for the private gain of any individual and its funds are applied wholly or mainly for charitable purposes (ie, the relief of poverty) within New Zealand. The organisation also runs a shop that sells office supplies (purchased from a wholesaler) to the public. The profit made from the shop is used to purchase food for the food bank.

71. The organisation has a policy of providing low-interest loans to all employees. Peter is employed by the organisation to work three days a week in the shop and two days a week in the food bank. He receives a low-interest loan from the organisation.

72. A fringe benefit arises to the extent to which Peter's employment consists of the charitable organisation carrying on a business activity that is outside the organisation's charitable purposes. In this case, 60% of Peter's employment is for the charitable organisation carrying on a business activity that is outside that organisation's charitable purposes. Therefore, the charitable organisation is liable for FBT on 60% of the value of the fringe benefit arising from the provision of the low-interest loan to Peter.

Example 5 – Voluntary work in food bank

73. This example has similar facts to Example 4, except that Peter is employed to work in the shop only two days a week, and for the remaining three days he volunteers to work for the organisation in the food bank. The low-interest loan is available to anyone who works regularly (as an employee or a volunteer) in the food bank.

74. In this situation, the organisation is not liable for FBT on the benefit arising from the provision of the low-interest loan to Peter. This is because the benefit is not received mainly in connection with Peter's paid employment, but instead is received mainly in connection with his unpaid role as a volunteer in the food bank. This is because Peter predominantly works as a volunteer in the food bank. The benefit is not a fringe benefit and therefore no apportionment is required.

Example 6 – Fuel card

75. A charitable organisation employs a secretary at its head office. The secretary's employment involves administrative matters relating to the running of the organisation. The secretary's salary is $40,000 for the tax year. On top of the salary, the organisation provides the secretary with a fuel card for use at a local petrol station. The fuel card is in the organisation's name and the organisation is liable to pay any amounts charged to the card. The secretary uses the card to obtain at least $80 worth of petrol every week.

76. The provision of the fuel card to the secretary is a fringe benefit. It does not matter that the secretary is employed in an activity within the charitable organisation's charitable purposes (ie, administrative work at an organisation's head office). The organisation is liable for FBT because the benefit is provided by way of a short-term charge facility and the value of the benefit is more than $1,200 in the tax year, being the lesser of 5% of the secretary's salary or wages for the tax year and $1,200. The benefit, therefore, is a fringe benefit under s CX 25(2).

References

Expired rulings

"Charitable Organisations and Fringe Benefit Tax (FBT): Public Ruling BR Pub 00/08", *Tax Information Bulletin* Vol 12, No 9 (September 2000): 3

"Public Ruling BR Pub 09/03: Charitable Organisations and Fringe Benefit Tax", *Tax Information Bulletin* Vol 21, No 6 (August 2009): 12

Subject references

business

charitable organisation

FBT

fringe benefit

fringe benefit tax

Other references

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Tax Information Bulletin Vol 16, No 5 (June 2004)

Legislative references

Charities Act 2005

Income Tax Act 2007, ss YA 1 (definitions of "business", "charitable organisation", "donee organisation"), CX 2, CX 25, LD 3(2), and sch 32

Tax Administration Act 1994, s 91DE(4A)

Case references

Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)

CIR v Banks (1978) 3 NZTC 61,236 (CA)

Grieve v CIR (1984) 6 NZTC 61,682 (CA)

Oxfam v City of Birmingham District Council [1975] 2 All ER 289 (HL)

Trustees of the Dean Leigh Temperance Canteen v Commissioners of Inland Revenue (1958) 38 TC 315 (HCJ (ChD))

BINDING RULINGS

Appendix: Legislation

1. Section CX 2(1) states:

Meaning

(1) A **fringe benefit** is a benefit that—

(a) is provided by an employer to an employee in connection with their employment; and

(b) either—

(i) arises in a way described in any of sections CX 6, CX 9, CX 10, or CX 12 to CX 16; or

(ii) is an unclassified benefit; and

(c) is not a benefit excluded from being a fringe benefit by any provision of this subpart.

2. Section CX 25 states:

CX 25 Benefits provided by charitable organisations

When not fringe benefit

(1) A charitable organisation that provides a benefit to an employee does not provide a fringe benefit except to the extent to which—

(a) the employee receives the benefit mainly in connection with their employment; and

(b) the employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes.

When employer provides charge facilities

(2) Subsection (1) does not apply, and the benefit provided is a fringe benefit, if a charitable organisation provides a benefit to an employee by way of short-term charge facilities and the value of the benefit from the short-term charge facilities for the employee in a tax year is more than the lesser for the tax year of—

(a) 5% of the employee's salary or wages:

(b) $1,200.

Meaning of short-term charge facilities

(3) For the purposes of the FBT rules, a **short-term charge facility** means an arrangement that—

(a) enables an employee to obtain goods or services that have no connection with the employer or its operations by—

(i) buying or hiring the goods or services:

(ii) charging the cost of the goods or services to an account:

(iii) providing consideration other than money for the goods or services; and

(b) requires the employer to provide some or all of the payment or other consideration for the goods or services; and

(c) is not a fringe benefit under section CX 10.

3. Section LD 3(2) states:

LD 3 Meaning of charitable or other public benefit gift

…

Description of organisations

(2) The following are the entities referred to in subsection (1)(a) and (b):

(a) a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic, or cultural purposes within New Zealand:

(ab) an entity that, but for this paragraph, no longer meets the requirements of this subsection, but only for the period starting on the day it fails to meet those requirements and ending on the later of—

(i) the day the entity is removed from the register of charitable entities under the Charities Act 2005:

(ii) the day on which all reasonably contemplated administrative appeals and Court proceedings, including appeal rights, are finalised or exhausted in relation to the person's charitable status.

(ac) a community housing entity, if the gift is made in a tax year that the entity meets the requirements to derive exempt income under section CW 42B (Community housing trusts and companies):

(b) a public institution maintained exclusively for any 1 or more of the purposes within New Zealand set out in paragraph (a):

(bb) a Board of Trustees that is constituted under Part 9 of the Education Act 1989 and is not carried on for the private pecuniary profit of any individual:

(bc) a tertiary education institution:

(c) a fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a), by a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual:

(d) a public fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a).

4. "Business" is defined in s YA 1 as including:

any profession, trade, or undertaking carried on for profit.

5. "Charitable organisation" is defined in s YA 1:

charitable organisation—

(a) means, for a quarter or an income year, an association, fund, institution, organisation, society, or trust to which section LD 3(2) (Meaning of charitable or other public benefit gift) or schedule 32 (Recipients of charitable or other public benefit gifts) applies—

(i) in the quarter; or

(ii) in the income year, if fringe benefit tax is payable on an income year basis under section RD 60 (Close company option); and

(ab) includes a person who has been removed from the register of charitable entities (the **register**) under the Charities Act 2005, but only for the period starting on the day the person is registered on the register and ending on the earlier of the last day of the following periods:

(i) the quarter, or income year if section RD 60 (Close company option) applies, in which the person does not comply with their rules contained in the register:

(ii) the quarter, or income year if section RD 60 applies, in which the day of final decision falls; and

(b) does not include a local authority, a public authority, or a university.

Notice of Withdrawal of a Public Ruling – BR Pub 09/03

1. This is a notice of withdrawal of a public ruling made under section 91DE of the Tax Administration Act 1994.
2. Public Ruling BR Pub 09/03 " Charitable Organisations and Fringe Benefit Tax" applies for an indefinite period beginning on the first day of the 2008/09 income year.
3. Public Ruling BR Pub 09/03 is withdrawn from 30 June 2017.

BR Pub 09/03 is being withdrawn because the Commissioner's view on aspects of that ruling has changed. On withdrawal, the Commissioner will continue to be bound by it for arrangements entered into on or before the withdrawal date for a further three years (see s 91DE(4A) of the Tax Administration Act 1994).

A new replacement public ruling, BR Pub 17/06 "Charitable and Other Donee Organisations and Fringe Benefit Tax" is being published with effect from 1 July 2017. The replacement ruling will apply to any new arrangements entered into on or after 1 July 2017. Organisations qualifying for the FBT exclusion may choose whether to apply the new ruling to their existing arrangements, but after 30 June 2020 the new ruling will apply to **all** arrangements providing fringe benefits, regardless of when they were entered into.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

TAXATION (ANNUAL RATES FOR 2016–17, CLOSELY HELD COMPANIES, AND REMEDIAL MATTERS) ACT 2017

The Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill was introduced on 3 May 2016. It received its first reading in Parliament on 15 June 2016, its second reading on 9 March 2017 and the third reading on 23 March 2017. The new Act received Royal assent on 30 March 2017.

The new Act sets the annual rates for income tax for the 2016–17 tax year and makes changes to improve, strengthen and update the rules for closely held companies, non-resident withholding tax and the approved issuer levy, and the goods and services tax rules. It also contains a large number of technical changes to ensure the tax rules work as intended.

Supplementary Order Paper No.261 released on 21 February 2017 provided specified tax relief for business affected by the Kaikoura earthquakes of 14 November 2016.

The Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 amends the Income Tax Act 2007, Tax Administration Act 1994, Goods and Services Tax Act 1985, Stamp and Cheque Duties Act 1971, Student Loan Scheme Act 2011, Child Support Act 1991, Income Tax Act 2004, Privacy Act 1993 and the Goods and Services Tax (Gants and Subsidies) Order 1992.

CLOSELY HELD COMPANIES

The amendments in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 aim to simplify the rules and reduce compliance costs, while ensuring that the rules remain robust and in line with intended policy.

Closely held companies typically have just a few shareholders but can have widely varying net worth and business focus. They also make up a significant proportion of the total number of companies in New Zealand. Many use the standard company tax rules but there are also specific tax rules available for very closely held companies, in particular, the look-through company (LTC) rules and their predecessor, the qualifying company (QC) rules.

The LTC and QC rules recognise that companies are taxed differently from individuals and it is important that this tax difference does not influence business decisions on whether to incorporate as this may impede growth. For example, a business may start off as a sole trader and, as it grows, decides to become a company, given the legal benefits of limited liability. The LTC rules, in effect, enable individual tax treatment to continue to apply to owners' LTC interests even though the LTC is legally a company for other than tax purposes. On the other hand, it is important that these rules be available only to those that could have genuinely alternatively operated through direct ownership.

The Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 makes a number of changes to the LTC rules, QCs and, through a number of changes to the dividend rules, other types of companies.

The key changes relate to the following:

LTCs

- eligibility criteria;
- entry tax;
- the deduction limitation rule; and
- debt remission.

QCs

- continuity of ownership; and
- ex-qualifying companies and the inter-corporate dividend exemption.

Other companies

- tainted capital gains;
- resident withholding tax on dividends; and
- the taxation of shareholder-employees' employment income.

Application dates

Most of the proposed changes apply from the beginning of the 2017–18 income year, or 1 April 2017, although some, such as those relating to debt remission, have been backdated where appropriate.

Look-through company eligibility criteria

Sections YA 1 and HZ 4E of the Income Tax Act 2007

Several amendments have been made to tighten the LTC eligibility criteria to ensure that LTCs operate as closely controlled companies, as originally intended. The changes relate in particular to who can have an interest in a LTC and how the five or fewer "counted owners" test applies. The changes are as follows:

- The way that beneficiaries are counted when determining whether the counted owner test is met has been broadened.
- Charities and Māori authorities are precluded from being LTC owners, directly or indirectly, subject to certain exemptions and grandparenting provisions.
- Trusts that own LTCs are precluded from making distributions to corporate beneficiaries.
- The foreign income that a foreign-owned LTC can earn annually is limited.
- The restriction that requires a LTC to have only one class of shares has been relaxed.

A transitional rule applies so that LTCs that will lose their LTC eligibility as a result of these amendments can convert to ordinary companies without any immediate tax consequences.

Background

The eligibility criteria limit the type of entity that can elect to become, and continue to be, a LTC as well as the type of owner that can hold LTC interests. They serve to ensure that the use of the LTC rules is appropriately targeted according to the policy intent. That is, that the rules should only be available to those that could have genuinely alternatively operated through direct ownership. That implies that ownership is held by a few shareholders; LTCs are not designed to be widely held entities. Accordingly the rules require LTCs to have no more than five counted owners to ensure that the company is "closely controlled" by individuals, and the rules specifically limit the number of owners to five look-through owners.

The concern covers not only direct ownership but also indirect ownership through benefiting from a distribution from a trust that has an ownership interest in a LTC. For example, the previous rules allowed for charities and Māori authorities to hold LTC interests, either directly or indirectly through a trust. Both charities and Māori authorities have potentially wide pools of beneficiaries and are therefore, conceptually, not part of the LTC target group.

Likewise, other amendments primarily focus on strengthening the rules supporting the requirement for a LTC to have no more than five counted owners.

Corporate ownership is precluded, given the scope that it would allow for widely held ownership. Another LTC can be an owner but is "looked through" to its owners for the purposes of determining whether the maximum of five counted owners test is met.

However, this prohibition on corporate ownership was previously undermined by allowing indirect corporate ownership through trusts.

Family trusts can be owners but specific rules determine the extent to which the trustee(s) and beneficiaries are counted owners. The previous rules were considered to be too narrow in that not all beneficiaries were taken into account.

Other new rules deal with concerns about LTCs being used by non-resident owners as conduits for investment outside of New Zealand.

No change has been made to the rule that states that if a LTC fails to satisfy the eligibility criteria during an income year it loses its LTC status from the beginning of that income year.

Key features

The definition of "look-through counted owner" in section YA 1 provides the mechanism for counting owners when testing whether the entity has met the requirements of having five or fewer counted owners. The amendments introduce a new limb to the definition with respect to LTCs owned by trusts to broaden the way that beneficiaries are counted, by including any beneficiary who receives any distribution from any source from the trust.

The definition of "look-through company" has also been amended to preclude charities and Māori authorities from becoming LTC owners (either directly or indirectly through a trust). The new restrictions do not however apply to Māori authorities and charities with existing ownership interests in LTCs that are, in effect, grandparenting structures or arrangements that were in place as at the date of the Bill's introduction (3 May 2016).

To ensure the prohibition on charity ownership does not inadvertently discourage charitable giving, a new rule allows trusts that own LTCs to continue making distributions to beneficiaries that are charities, so long as the distribution is akin to a donation or is received by the charity as a residual beneficiary of the trust.

To bolster the existing legislative prohibition on direct corporate ownership of LTCs, the definition of "look-through company" has been further amended to prohibit a trust that owns a LTC from making any distributions to any corporate beneficiaries.

LTCs are not intended to be conduit vehicles for international investment by non-residents whereby funds are invested through New Zealand rather than into New Zealand. To restrict the use of LTCs in this conduit manner, the foreign income that can be earned by a LTC that is controlled by foreign LTC holders is now limited to the greater of $10,000 and 20 percent of the LTC's gross income in the relevant income year. A definition of "foreign LTC holder" provides the rule for determining how the foreign ownership of LTCs is tested when applying the new foreign income restriction. It is defined as "ownership interest held more than 50% by non-residents".

An amendment to the definition of "look-through interest" enables LTCs to have more than one class of shares. This amendment will enable LTCs to have shares carrying different voting rights, provided all shares have uniform entitlements to all distributions.

A transitional rule applies so that LTCs that will lose their LTC eligibility as a result of these amendments can convert to ordinary companies without any immediate tax consequences. This means that the "exit tax" (deemed realisation of assets and liabilities) will not arise for these LTCs and any unrealised revenue account gains will not be realised for owners at that stage.

Application dates

All the amendments, except the foreign income restrictions, apply for the 2017–18 and later income years.

The amendments to limit the foreign income of foreign-controlled LTCs apply for income years beginning on or after 1 April 2017. This means that for taxpayers with early balance dates, the foreign income restrictions apply for the 2018–19 income year.

Detailed analysis

Counting beneficiaries of trusts

Previously, for LTCs owned by trusts, when determining the number of look-through owners, the rules counted the trustee (grouping multiple trustees as one) when the LTC income earned by the trust was not fully distributed to beneficiaries, as well as all beneficiaries who had received LTC income from the trust as "beneficiary income" in the current and preceding three years. This was too narrow.

Accordingly, the definition of "look-through counted owner" has been amended to count all distributions to beneficiaries, irrespective of whether they are from the LTC or from other sources, or whether they are received by the beneficiary as beneficiary income, trustee income, trust capital or corpus.[1] The amendment is necessary to ensure the test counts all persons who, though they may not receive beneficiary income, nevertheless benefit from the trust owning LTC shares. Including all distributions is also necessary to ensure the rule is not undermined by the fungibility of money, which makes the result from tracing the source of a distribution arbitrary.

Transitional rule

To ensure the revised distributions rule applies only prospectively, the time period over which distributions are measured has not been changed. The counted owner test continues to look back to the current and preceding three income years. A transition rule will apply over the next four years which involves applying both tests depending on the relevant time periods involved.

[1] For a trust, corpus means an amount that is equal to the market value of a settlement of property on the trust measured at the date of the settlement.

The strengthened test will only apply to income earned from the beginning of the 2017–18 income year. Income earned and distributed to beneficiaries or retained by the trust prior to the 2017–18 income year will be counted under the old test.

Those entities that were LTCs in the 2016–17 income year will (with all other things being equal) retain their LTC status if:

- they continue to meet the current test over the three to four-year measurement period; and
- having applied the new test (measuring distributions made only from the beginning of the 2017–18 income year) to establish whether there are any additional counted owners; and
- in aggregate, there are a maximum of five look-through counted owners.

This means that for the 2017–18 income year a person would look at distributions provided between the 2014–15 income year to the 2016–17 income year and apply the old test which looks at income sourced from a LTC interest to determine whether any beneficiaries are look-through counted owners. The person would then apply the new rule for any distributions in the 2017–18 income year to determine whether there are any additional look-through counted owners.

The legislation is expressed in terms of "persons" rather than counted owners so there is no double counting of the same person if they receive a counted distribution prior to 2016–17 as well as a distribution after the 2016–17 income year.

For the 2018–19 income year the person would look at distributions provided in the 2015–17 income years and apply the old test and then look at distributions in the 2017–19 income years and apply the new test.

The transition is summarised in the following table:

For income year	Which test to apply	Previous year 3	Previous year 2	Previous year 1	Current year
2017–18	Old test	2014–15	2015–16	2016–17	-
	New test	-	-	-	2017–18
2018–19	Old test	2015–16	2016–17	-	-
	New test	-	-	2017–18	2018–19
2019–20	Old test	2016–17	-	-	-
	New test	-	2017–18	2018–19	2019–20
2020–21	Old test	-	-	-	-
	New test	2017–18	2018–19	2019–20	2020–21

To ensure the strengthened test incorporating all distributions to beneficiaries does not result in double counting of owners, under the new rules trustees are only look-through counted owners when no beneficiaries of the trust are look-through counted owners.

Example

A LTC is 100 percent owned by a Trust A. Trust A has five listed beneficiaries. From 1 April 2017 to 31 March 2020 the trust has made no distributions to any of the beneficiaries.

As a result, for the 2019–20 income year, none of the five beneficiaries are look-through counted owners. As the trust has no beneficiaries as look-through counted owners, the trustee is a look-through counted owner and the LTC has a total of one look-through counted owner for the income year.

Example

A LTC is 100 percent owned by Trust A. In the 2016–17 income year, Trust A made distributions to 10 beneficiaries that were from non-LTC sourced income.

In the 2017–18 income year, these 10 beneficiaries will not be look-through counted owners as distributions in the 2016–17 are considered under the old rules which do not consider distributions of non-LTC sourced income. If there are no other distributions the trustee will be a counted owner in these circumstances.

Example

A LTC is 100 percent owned by Trust B.

Trust B has made the following distributions:

2015–16 income year: Distribution of LTC-sourced income to two beneficiaries.

2016–17 income year: Distribution of non-LTC sourced income to two beneficiaries.

2017–18 income year: Distribution of non-LTC sourced income to two beneficiaries.

2018–19 income year: No distributions to date.

All of the beneficiaries are separate individuals.

For the 2018–19 income year, the LTC will have four look-through counted owners. This is made up of the two beneficiaries who received distributions in the 2015–16 income year and the two beneficiaries who received distributions in the 2017–18 income year.

The two beneficiaries who received distributions in the 2016–17 income year are not look-through counted owners as distributions for the 2016–17 income year are counted under the old rules which do not consider distributions of non-LTC sourced income.

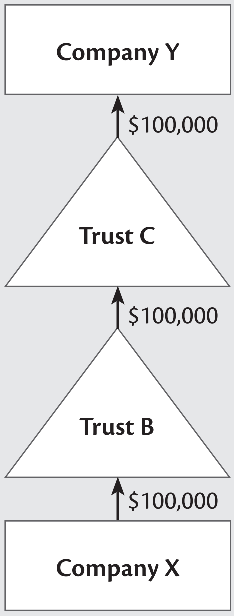
Corporate beneficiaries

Under the previous rules, a trust that owned a LTC interest could have a corporate beneficiary but direct ownership by companies, other than other LTCs, was expressly prohibited. The trust was looked through and the shareholders of the corporate beneficiary counted if it received any beneficiary income. This, coupled with the way that the number of owners was determined for trusts, unintentionally provided widely held non-LTC corporates with a way to circumvent the prohibition on direct ownership. This could be used to obtain inappropriate tax advantages.

The definition of "look-through company" has been amended to expressly prohibit trusts that own LTCs from making distributions to corporate beneficiaries either directly or indirectly.

This approach in effect allows for grandparenting of current structures involving corporate beneficiaries, by not expressly prohibiting LTC-owning trusts from having corporate beneficiaries (so long as the trust does not make further distributions to the company) while strengthening the prohibition on ownership of LTCs by standard companies.

Example: Indirectly a beneficiary of the trust



- Trust B is a shareholder of Company X.
- Trust C is a beneficiary of Trust B.
- Company Y is a beneficiary of Trust C.

Company X makes a distribution to Trust B. Trust B then passes on the distribution to Trust C who passes it to Company Y.

Company X will be ineligible to be a LTC. This is because a trustee shareholder of Company X has made a distribution of income to a company that is indirectly a beneficiary of the trust.

Voting rights

Previously, in order to simplify the attribution of a LTC's income and expenditure to its underlying owners, LTCs could only have one class of share. This rule was overly restrictive as it could limit legitimate commercial structuring or generational planning and inhibit some companies from becoming LTCs.

Accordingly, the requirement has been relaxed through amending the definition of "look through interest". The amendment allows a LTC to have shares that carry different voting rights provided that all shares still have the same rights to distributions.

Charities and Māori authorities

To ensure that the LTC rules are reserved for closely controlled entities, amendments have been made that extend the trust approach of looking through to the ultimate beneficiaries to LTCs owned by tax charities (as defined in the Income Tax Act) and Māori authorities. The amendments effectively preclude direct ownership by charities and direct or indirect ownership by Māori authorities. There are however some exceptions to this.

"No strings attached" distributions to charities

An amendment to the definition of "look-through company" allows distributions by LTCs or shareholding trusts of LTCs to charities which have no influence over the LTC or shareholding trust. This enables genuine gifts from LTCs or shareholding trusts to be made to charities and recognises that many LTCs may want to make charitable distributions.

Grandparenting existing Māori authorities and charities

The amendments provide grandparenting for existing Māori authority and charity interests in LTCs through the definitions of "grand-parented charity" and "grand-parented Māori authority.

This will enable these entities to avoid the compliance cost of converting their LTC interests to limited partnerships, which are another look-through vehicle that is often used to achieve the same outcome as a LTC.

The amendments only enable Māori authorities and charities to hold interests in LTCs which they had an interest in prior to 3 May 2016 (the date of introduction for the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill).[2]

[2] This includes arrangements entered into before 3 May 2016 to become an owner in a LTC.

This means that Māori authorities and charities can change the amount of shareholding they have in LTCs they had an interest in prior to 3 May 2016, but cannot acquire interests in new LTCs that they did not have an interest in before that date.

Example

Charity X is a tax charity which, on 15 April 2015, acquired a 50 percent shareholding in Widgets Ltd. On 1 April 2016 Widgets Ltd elected to become a LTC.

On 2 May 2017, Charity X increased its shareholding in Widgets Ltd to 100 percent.

As Charity X acquired its interest in Widgets Ltd before 3 May 2016, its interests in Widgets Ltd. are grandparented and Widgets Ltd can maintain its LTC status despite Charity X's ownership interest. The increase in shareholding by Charity X on 2 May 2017 also does not affect the LTC status of Widgets Ltd, due to the grandparenting.

Foreign income restrictions

Although LTCs are envisaged primarily as a structure for domestically focused companies, under the previous rules there were no restrictions on either foreign investment by LTCs or on LTCs having non-resident owners. This combination unintentionally allowed for LTCs to be used as conduit investment vehicles – that is, New Zealand domiciled vehicles used by non-residents to invest in foreign markets generating income generally not taxable in New Zealand. This gave rise to reputational risks for New Zealand.

To address these risks, amendments have been made to the definition of "look-through company" to restrict the amount of foreign income that a foreign-controlled LTC (a LTC that is more than 50 percent held by non-residents) can derive.

The amendments provide that a company is ineligible to be a LTC if both:

- more than 50 percent of the total ownership interest in the company is held by foreign LTC holders (as defined); and
- the entity has foreign-sourced amounts for the income year that in total are more than $10,000 and 20 percent of the company's gross income for the year.

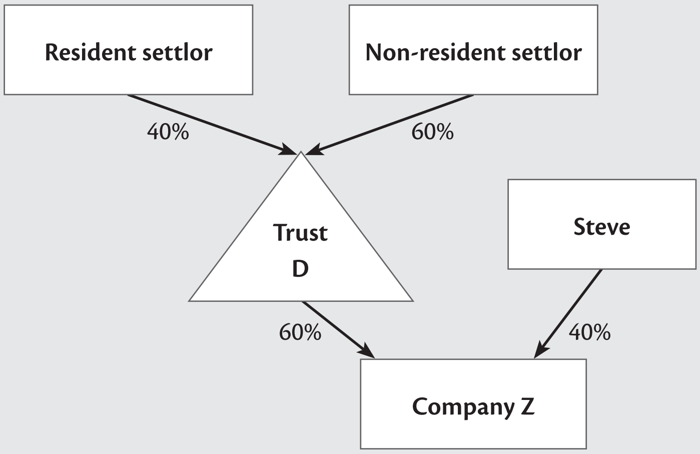
The thresholds are intended to provide flexibility for some degree of combined non-resident shareholding and foreign income, and should prevent a domestic family business inadvertently falling outside the rules through an owner emigrating. On the other hand, the amendment is intended to prohibit LTCs being used by non-residents purely as conduit investment vehicles.

Definition of "foreign LTC holders"

The rule tests foreign control by looking at the direct and indirect ownership of the LTC, and testing the tax residence of the owners. Standard tests of residency will apply to determine the residency of individuals.

A trust that has foreign settlors is considered to be a foreign LTC holder only to the extent of the proportion of the value of settlements made by the non-resident settlors. For example, if a trust held 50 percent of the shares in a company, and 50 percent of the value of settlements made on the trust were by non-residents, then 25 percent of the ownership interests in the company would be considered to be held by foreign LTC holders. In determining the proportion of the value of settlements made by non-resident settlors, provisions of services at below market value are not counted. These services are not counted due to the difficulty in valuing them.

Example



Company Z has two shareholders, Trust D which has a 60 percent shareholding in Company Z and Steve, who holds a 40 percent shareholding.

Steve is an individual who is resident in New Zealand.

Trust D is a trust which received $100,000 in cash settlements, $60,000 of the settlements were made by a non-resident settlor and $40,000 were made by a resident settlor. Trust D's 60 percent shareholding in Company Z is therefore split between treated as being held by non-residents and residents on a 36:24 basis.

Overall, 36 percent of Company Z's shares are considered to be held by foreign LTC holders and 64 percent (40 percent and 24 percent) held by residents. Because of this, the foreign income restrictions will not apply to Company Z.

Transitional rule

Section HZ 4E provides a transitional rule for companies that will lose LTC status as a result of the amendments to the eligibility criteria for LTCs. Section HB 4(6) provides that these LTCs will be able to transition to being ordinary companies without triggering the exit adjustment requirements in section HB 4(6).

This transitional rule applies when an entity is a look-through company at the end of the 2016–17 income year and ceases to be a LTC because of one of the eligibility changes referred to above.

In this situation the section provides that section HB 4(6) does not apply. Section HB 4(6) ordinarily treats a LTC that transitions to an ordinary company as selling all of its assets to a third party at market value and then reacquiring them as an ordinary company. This results in a realisation of any revenue account gains on the LTC's assets, which becomes income of the owners.

Instead section HZ 4E provides that the company is treated as having the same tax position it had as a LTC. This means that any assets of the LTC are transferred at book value, and the company is treated as having acquired them on the same date as the LTC and with the same intention.

Example

Speculator Ltd is a LTC that is involved in property renting and speculation. On 1 May 2015, Speculator Ltd acquired land for $500,000 with the intention of reselling. Speculator Ltd sells the land on 5 August 2020 for $700,000.

On 1 June 2017, Speculator Ltd. made a distribution to a corporate beneficiary. As a result, Speculator Ltd will lose LTC status as a result of the eligibility changes in the new rules.

When Speculator Ltd becomes an ordinary company it will be treated as having acquired the land on 1 May 2015 for $500,000 and with the intention of resale. Any increase in the value of the property will not be realised upon Speculator Ltd exiting the LTC rules. Instead any revenue account gains will be brought to account when Speculator Ltd actually sells the land – in this case on 5 August 2020 – realising a $200,000 revenue account gain.

NEW LEGISLATION

Look-through company entry tax

Sections CB 32C, HB 13, OB 6, RE 2 and YA 1 of the Income Tax Act 2007

Amendments to section CB 32C have been made, which modify the income adjustment calculation (commonly known as the entry tax) done when a company converts to a LTC to ensure that:

- the taxable income that arises to LTC owners as a result of the calculation is taxed at each shareholder's personal tax rate; and
- for QCs converting to LTCs, that the entry tax formula does not tax owners of QCs any more than they would be if they liquidated before the conversion.

An associated amendment to section HB 13 clarifies that a company that elects to become a LTC effectively steps into the shoes of the company it converted from and must use the tax book values of the company at the time of entry for all purposes under the LTC rules.

Background

The LTC entry tax adjustment applies when a company elects to become a LTC. It triggers a tax liability on un-imputed retained earnings by deeming the company to have been liquidated immediately prior to conversion. This adjustment is intended to ensure that reserves that would generate taxable income for shareholders if distributed before entering the LTC regime and that would be able to be distributed tax-free once the company becomes a LTC, are taxed to owners at the time of entry.

The tax rate used in the old formula was 28%, which means that no further tax was paid on the company's retained earnings. The 28% rate was used in the formula to reduce compliance costs, but this could provide a tax advantage for shareholders whose top personal tax rate exceeded 28% (that is, those on the 30% or 33% marginal tax rate) as well as a disadvantage for shareholders whose personal tax rates were below 28%.

Further, the entry tax formula applied to tax all un-imputed retained earnings except eligible capital profits. For QCs that elected into the LTC rules, this meant tax was charged to the extent that the earnings were not eligible capital gains. This approach was inconsistent with the QC rules, which allow for tax-free distribution of un-imputed earnings as exempt dividends to QC shareholders. As a result, the entry tax formula could over-charge tax on the un-imputed reserves, which may have deterred some QCs from converting to LTCs.

Key features

A revised formula treats the resulting income that flows through to the LTC owners as a dividend, with imputation credits attached where available, thereby ensuring that the income is taxed at the owners' personal tax rates in all cases.

This overcomes a problem with the previous formula, which based the calculation on the company tax rate and could lead to under- or over-taxation, depending on an owner's marginal tax rate.

A further formula covers situations when a QC has insufficient tax credits to cover distributions of all reserves.

An amendment also clarifies that the tax book value of assets and liabilities of a company that elects into the LTC regime become the opening book values for the LTC, for the avoidance of doubt. For example, revenue account property transfers at tax book value, and not market value, meaning that unrealised gains and losses are not recognised at that point.

The amendment also clarifies that the LTC has the same status, intention and purpose in respect of its assets, liabilities and associated legal rights and obligations. For example, if a company acquired land on 8 August 2017 with an intention of resale and subsequently converts to a LTC, the LTC will be treated as also acquiring the land on 8 August 2017 with an intention of resale.

Application date

The amendments apply for the 2017–18 and subsequent income years.

Detailed analysis

The current formula in section CB 32C(5) is:

$$\textit{dividends} + \textit{balances} - \textit{assessable income} - \frac{\textit{balances}}{\textit{tax rate}} - \textit{exit exemption}$$

where:

dividends is the sum of the amounts that would be dividends if, immediately before becoming a LTC, the property of the company, other than cash, were disposed of at market value, the company met all its liabilities at market value and it was liquidated, and the net cash amount was distributed to shareholders without imputation credits or foreign dividend payment credits attached. In other words a liquidation took place;

balances is the sum of the balances in the imputation credit account and foreign dividend payment credit account immediately before becoming a LTC, plus amounts of income tax payable for an earlier income year but not paid before the relevant date, less refunds due for the earlier income year but paid after the relevant date;

assessable income is the amount of income that would arise as a result of liquidation less any deductions that the company would have as a result of liquidating. This includes depreciation gains or losses, bad debts and disposals of revenue account property;

tax rate is the company tax rate in the income year before the income year in which the company becomes a LTC;

exit exemption is the exit dividends that, if the company had previously been a LTC and is now re-entering the LTC rules, would be attributed to any retained reserves from the previous LTC period that have not since been distributed.

The new formula in section CB 32C(4) is:

(untaxed reserves + reserves imputation credit) × *effective interest*

where:

reserves imputation credit is the total amount of credits in the company's imputation account, up to the maximum permitted ratio for the untaxed reserves under section OA 18 (Calculation of maximum permitted ratios) and is treated as an attached imputation credit included in the dividend calculated;

effective interest is the person's effective look-through interest for the look-through company on the relevant day; and

untaxed reserves is calculated using the following formula:

dividends – assessable income – exit exemption

where:

dividends is the sum of the amounts that would be dividends if the following events occurred for the company or the amalgamating company, immediately before it became a look-through company or amalgamated with a look-through company:

(i) it disposed of all of its property, other than cash, to an unrelated person at market value for cash; and

(ii) it met all of its liabilities at market value, excluding income tax payable through disposing of the property or meeting the liabilities; and

(iii) it was liquidated, with the amount of cash remaining being distributed to shareholders without imputation credits attached;

assessable income is the total assessable income that the company would derive by taking the actions described in subparagraphs (i) and (ii) above; less the amount of any deduction that the company would have for taking those actions;

exit exemption is the amount given by the formula in section CX 63(2) (Dividends derived after ceasing to be a look-through company), treating the amount as a dividend paid by the company for the purposes of section CX 63(1), if section CX 63 would apply to a dividend paid by the company.

The terms "dividends, "assessable income" and "exit exemption" are therefore the same as in the previous formula.

This proposed formula will treat the retained income and imputation credits that would arise on liquidation of the company as being distributed to the individual LTC owners who will need to include the income and imputation credits in their return of income. This approach leaves it to each individual shareholder to determine what tax rate applies to their share of the income, and results in a fairer tax outcome.

The formula will apply to companies converting to LTCs, including QCs with sufficient imputation credits to fully impute the dividend, as well as companies that amalgamate with LTCs. However, it will not apply to those QCs converting to LTCs for which the entry tax formula would result in a dividend which is not fully imputed.

Qualifying companies with limited imputation credits

Instead the proposed additional formula in section CB 32C(8) is to be used to calculate the entry tax payable when a dividend by a QC on liquidation would be only partially imputed and, therefore, only partially a taxable distribution. The proposed formula in this case is:

$$\left(\frac{\textit{balances}}{\textit{tax rate}} - \textit{balances}) + \textit{balances imputation credit}\right) \times \textit{effective interest}$$

NEW LEGISLATION

where:

balances is the sum of the following amounts:

(i) the balance in the company's imputation credit account;

(ii) an amount of income tax payable for an earlier income year but not paid before the relevant date, less refunds due for the earlier income year but paid after the relevant date;

tax rate is the basic tax rate for the income year of the company that contains the relevant day;

balances imputation credit is the same as the amount of the item balances, and is treated as an attached imputation credit included in the dividend calculated;

effective interest is the person's effective look-through interest for a look-through company on the relevant day.

Benchmark dividends

An amendment to section OB 61 (ICA benchmark dividend rules) ensures that the dividend which results from the entry tax formula is disregarded for the purposes of the benchmark dividend rules. This amendment is for the avoidance of doubt that the level of imputation attaching to the entry tax deemed dividend does not require a benchmark dividend ratio change declaration as the company is not an imputation credit account (ICA) company as defined in section OB 1 of the Income Tax Act at the time that the dividend arises.

Example

X Co is an ordinary company. It has two shareholders: Amy, who has 40 percent of the shareholding in X Co, and Ben, who holds 60 percent of the shareholding in X Co.

$500,000 of equity was put into X Co, which X Co used to purchase a $500,000 house it acquired with the intention of resale. The house is now worth $700,000. X Co also has $72,000 of retained earnings and $28,000 of imputation credits from rent received from the house.

X Co converts to a LTC. As a result, an entry tax calculation is required. The formula is:

(untaxed reserves + reserves imputation credit) × effective interest

The reserves imputation credit is $28,000. Amy's effective interest is 40 percent and Ben's effective interest is 60 percent.

Untaxed reserves

Untaxed reserves are calculated using the formula:

Dividends – assessable income – exit exemption

The dividends are the amounts that would be dividends if X Co sold its $700,000 house, then liquidated. If X Co liquidated it would have $272,000 of dividends, being the $700,000 cash from the property, the $72,000 of retained earnings, minus the subscribed capital of $500,000.

The assessable income of X Co would be $200,000, being the total assessable income that X Co received from the sale of the house (as it was held on revenue account).

The exit exemption would not apply as X Co has not previously been a LTC.

As a result, the untaxed reserves are $72,000.

As a result, the entry tax calculations are:

Amy: (72,000 + 28,000) × 0.4 = $40,000

Ben: (72,000 + 28,000) × 0.6 = $60,000

These are treated as dividends and imputation credits may be attached to them. Amy may have up to $11,200 of imputation credits attached, and Ben may have up to $16,800 of imputation credits attached.

Deduction limitation rule

Sections GB 50 and HB 11 of the Income Tax Act 2007

The coverage of the deduction limitation rule, which limits a LTC owner's LTC deductions to the amount that they have economically at risk, has been restricted to LTCs in partnership or joint venture.

To bolster the other rules in the Income Tax Act that help to stop LTC owners claiming excessive deductions, the existing anti-avoidance rule that deems a partner's transactions to be at market value has been extended to owners of LTCs.

Background

The deduction limitation rule was designed to ensure that LTCs cannot be used to generate deductions in excess of the money that owners have at risk in the company. It was based on a comparable rule that applies to limited partnerships. It works by restricting an owner's ability to use LTC deductions against their other income when the deductions are greater than the owner's economic contribution to the LTC (referred to as "owner's basis").

The rule results in undue compliance costs in many cases, as it requires each LTC owner to calculate their "owner's basis" annually, which requires owners to keep track of what they have invested in and withdrawn from the business, and all income and expenditure attributed to them while they have been an owner. Over time this would require LTC owners to maintain records well beyond the standard record-keeping period for tax information. Furthermore, each owner must complete the calculation even though most will not have their deductions constrained by it because their share of net expenditure is less than their owner's basis.

Overall, given that this rule results in compliance costs that appear to outweigh the benefits provided from the operation of the rule, the rule is largely unnecessary in the LTC context. However, for LTCs working together in partnership or as a joint venture, the rule has relevance. This is because partnerships and joint ventures of LTCs are in many respects an alternative to limited partnerships where a deduction limitation rule is appropriate. They can also be potentially widely held vehicles.

The removal of the rule for other LTCs is considered appropriate, given that the risk of LTCs being used to generate excessive deductions is ameliorated by other rules in the Income Tax Act, including the general and specific anti-avoidance provisions and the debt remission amendments discussed in the following item.

Key features

The first amendment means that the deduction limitation rule in section HB 11 will not apply for most LTCs. The provision will be changed to specifically cover only LTCs that are in partnership or are members of a joint venture under section HG 1. The formula determining the "owner's basis" in section HB 11 will otherwise be unchanged, although officials are continuing to explore options for simplifying and clarifying the formula.

For those no longer covered by the rule, deductions previously restricted and carried-forward by the rule will be automatically freed up from the 2017–18 income year, and will be available for offsetting against their income from that year onwards.

The specific anti-avoidance rule in section GB 50 has been extended to LTCs and their owners. The rule is designed to ensure that transactions between partners and their partnerships that have the effect of defeating the rules in sub-part HG (joint ventures, partners and partnerships) are treated as taking place at market value.

Application date

The amendment to section HB 11 applies from the beginning of the 2017–18 income year.

The amendment to section GB 50 applies from 1 April 2017.

Debt remission

Sections DB 11, EW 31, EW 39, HZ 8 and YA 1 of the Income Tax Act 2007

Amendments to the debt remission rules have been made to deal with specific concerns about the way the rules work in relation to LTCs and partnerships.

Background

Debt arrangements with owners

Debt remission, being the extinguishing of a debtor's liability by operation of law or forgiveness by the creditor, gives rise to debt remission income to the debtor under the financial arrangement rules. Under current tax law, debt remission produces taxable income to the debtor.

Problems arise from the interaction of the LTC (and partnership) rules with the financial arrangement rules that produce remission income in circumstances when, as a result of the transparency of the LTC or partnership, the debt is effectively self-remitted. When an owner of a LTC remits debt owed to them by the LTC, all the LTC owners derive debt remission income given the look-through nature of a LTC. This includes the owner that remitted the debt who is required to pay tax on their share of the remission income despite making an economic loss (to the extent of the portion of the loan that is attributed to the other shareholders). Generally, they are unable to claim a deduction for the bad debt. Overall, this results in over-taxation of the owner who remitted the debt, which is not an appropriate policy outcome.

Market value of debts

The other change amends the LTC rules to clarify that when calculating the market value of an owner's interest as debtor in a financial arrangement with a third party, the amount of any adjustment for credit impairment must be taken into account. This clarification is necessary as Inland Revenue officials have become aware of certain interpretations being taken to the contrary.

The amendment will ensure that the debt remission rules apply as intended so that debt remission income arises when a LTC is either liquidated or elects out of the LTC rules. This is important given the proposed limiting of the scope of the deduction limitation rules, as the debt remission rules are one of the backstops in the Income Tax Act that help to preclude excessive deductions.

Key features

The first amendment ensures that remission income does not arise to either a LTC owner or a partner who remits a debt owed to them (referred to in the amendment as "self-remission") by the LTC or partnership, including a limited partnership. This also applies when an owner effectively remits the debt through an entity ceasing to be a LTC or similar deemed disposals of owners' interests.

The second clarifies that in respect of a debt owed by a LTC to a third party, the market value of the debtor's interest in the debt is adjusted for any credit impairment. While this was always the intention, some practitioners have argued otherwise.

Both amendments are necessary to ensure that the debt remission rules operate as intended.

Any refunds of overpaid tax as a result of the retrospective application can be claimed by taxpayers reopening past returns, but we do not anticipate many will need to do this. Any additional income that may arise as a result of retrospective application will only need to be brought to account in the 2017–18 income year (a transitional amendment achieves this).

Application dates

The first amendment to remission income applies to income years beginning on or after 1 April 2011, the start date of the LTC rules.

The second amendment to the valuation of credit impairment applies from 1 April 2011. However, to avoid reopening past returns, any additional income and associated penalties and interest from those earlier years is brought to account in 2017–18 income returns.

Detailed analysis

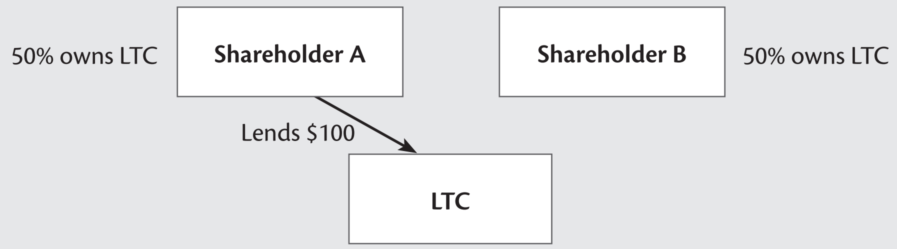
Debt remission

The new Act amends the financial arrangement rules to exclude self-remission by a shareholder of a LTC or a partner in a partnership. This is achieved by introducing the concept of a "self-remission" into the Act and enabling the shareholder or partner who has lent money to a LTC or partnership a deduction equal to their proportion of debt remission income of the LTC or partnership.

Section EW 31(11) has been amended so that the definition of "amount remitted" excludes a "self-remission". "Self-remission" is defined as an amount of remission for a person and a financial arrangement under which, and to the extent to which, because of the operation of sections HB 1 or HG 2 (which relate to LTCs and partnerships), the person is also liable as debtor in their capacity of owner or partner.

This exclusion means that a shareholder or partner of a LTC or partnership will have a negative base price adjustment in their capacity as a creditor that neutralises out any income attributed to them as debtor in their capacity as owner or partner.

Example



A LTC is 50 percent owned by two shareholders – Shareholder A and Shareholder B. Shareholder A lends $100 to the LTC. Shareholder A subsequently remits the $100 debt it owes to the LTC.

As a result of the remission both Shareholder A and the LTC need to make a base price adjustment (BPA).

LTC's base price adjustment

The base price adjustment formula is:

Consideration in – consideration out – income + expenditure + amount remitted

The LTC has received $100 in consideration and as a result its BPA is a positive amount of $100.

This $100 is attributed equally to the two shareholders under the LTC look through rules in section HB 1. As a result, Shareholder A has income of $50 and Shareholder B has income of $50.

Shareholder A's base price adjustment

Consideration in – consideration out – income + expenditure + amount remitted

Shareholder A has paid out consideration of $100 and has made a debt remission of $100. However, $50 of this debt remission is a "self-remission" under the amendments to section EW 31 as they are also liable as a debtor in their capacity as an owner of a LTC.

As a result, Shareholder A has a negative base price adjustment of $50.

Shareholder A is entitled to a deduction for this negative base price adjustment under section DB 11(1B) up to the amount of the self-remission ($50).

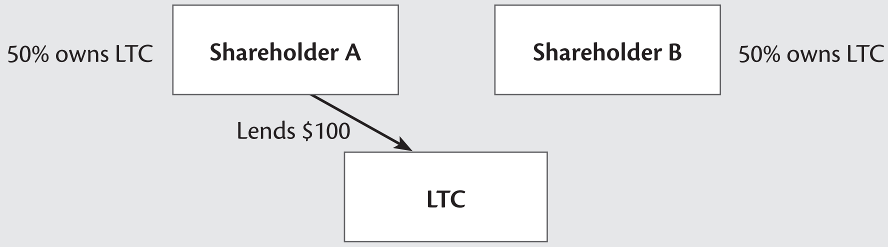
As a result, Shareholder A has income of $50 attributed from the LTC and a deduction of $50 and as a result has no net income from the remission. Shareholder B has income of $50 attributed from the LTC.

An amendment has been made to section EW 8 to allow taxpayers to treat arrangements that are excepted financial arrangements under section EW 5(10) as financial arrangements. This applies to persons who have made an interest-free loan in New Zealand currency that is repayable on demand. The ability to treat the loan as a financial arrangement enables a person who loans money to a LTC to get the benefit of the self-remission amendments when it would ordinarily be unavailable due to the loan being an excepted financial arrangement under section EW 5(10).

Disposals of financial arrangements

An equivalent amendment has been made to section EW 39 to ensure that the same result is achieved in circumstances when a LTC owner or a partner in a partnership dispose of their interests in the financial arrangement. For a LTC this can occur upon permanent cessation, capital reduction, or revocation of LTC status. For partnerships this can occur on sale of partnership interests by a partner or upon dissolution of a partnership.

Example



A LTC is 50 percent owned by two shareholders – Shareholder A and Shareholder B. Shareholder A lends $100 to the LTC.

The LTC becomes insolvent and cannot repay its debts. As part of a restructure the shareholders decide to convert the LTC to an ordinary company and as a result a base price adjustment is required for both the LTC and Shareholder A.

Base price adjustment for LTC

Similar to the previous example, the LTC has income of $100 which is attributed equally to Shareholder A and Shareholder B.

Base price adjustment for Shareholder A

Consideration in – consideration out – income + expenditure + amount remitted

Under the old section EW 39, Shareholder A would be treated as having been paid the full market value of the $100 debt as if the LTC was not insolvent.

Under the amendment to section EW 39, Shareholder A may subtract the amount of "self-remission" from this market value. As a result, shareholder A is treated as having been paid $50 for the debt.

As a result, Shareholder A has a negative base price adjustment of $50, which offsets the $50 of remission income so that its net income is $0.

Shareholder B on the other hand has income of $50 from its share of the remission income.

Market value of an owner's interest as a debtor

An amendment to section HB 4 has been made that clarifies that when calculating the market value of an owner's interest as a debtor in a financial arrangement, the amount of any adjustment for credit impairment must be taken into account. This ensures the debt remission rules work as intended so that when a debtor sells their interest in a financial arrangement that they will not be able to repay in full, they are treated the same as if the amount they are unable to repay was remitted.

Determining the amount of credit impairment

Under the new rules, debtors will not need to rely on information from the creditor to determine the amount of credit impairment. Instead, the debtors will need to make a fair and reasonable estimate of the credit impairment based on the information they have available.

To determine the credit impairment, the key question to ask is "if the LTC was sold or liquidated, how much of the debt would be repaid to the creditor?" In most cases, determining this would involve looking at the balance sheet of the LTC to determine the net assets of the LTC.

Example

Tara sets up a LTC to hold a rental investment property. The LTC gets a mortgage of $500,000 to finance the purchase of the property. The LTC has no insurance for the property.

Due to flooding, the rental property declines in value to $300,000. The LTC also has $50,000 in cash reserves. The only liability of the LTC is the mortgage which still has $500,000 outstanding.

Tara decides to liquidate the LTC. In determining the market value of the mortgage, Tara must ask "if the LTC was sold or liquidated, how much of the debt would be repaid to the creditor?" As the LTC has $350,000 in assets and no other liabilities other than the mortgage, the answer to this question is $350,000. When making the base price adjustment, this is the value of the arrangement for the LTC to use.

Transitional rule for market value amendment

A transitional rule ensures that any income that would have arisen in earlier income years through the retrospective application of this remedial clarification will be recognised prospectively in the 2017–18 tax year. This will reduce the consequences for taxpayers who should have had income arise in line with the intended operation of the disposal rules but who took a different tax interpretation and avoids the need to reopen past returns.

The formula under the transitional rule in section HZ 8 is:

retrospective amount – *current amount*

where:

retrospective amount is the amount of income, for the person's owner's interest in financial arrangements as debtor, that would result from the application of section HB 4 for income years before the 2017–18 income year, treating that section as amended by the clarification that the market value of the interest must take into account the amount of any adjustment for credit impairment, for those income years;

current amount is the amount of income, for the person's owner's interest in financial arrangements as debtor from the application of section HB 4 that the person returned for income years before the 2017–18 income year.

Qualifying companies – continuity of ownership

Sections HA 6 and YA 1 of the Income Tax Act 2007

An amendment to the qualifying company (QC) rules provides that qualifying company status will cease if there is a change in control of the company.

Background

Qualifying companies are partial look-through vehicles that allow for the profits of the company to be taxed in the same way as a standard company but, unlike a standard company, capital gains and un-imputed dividends can be distributed tax-free to shareholders during the course of business. QCs in place when the new LTC regime came into force on 1 April 2011 were allowed to continue, pending an ultimate decision on the future of QCs. There are still around 70,000 QCs.

As part of the Government's decisions from the review of closely held company taxation, it was confirmed that these QCs could continue. Requiring all remaining QCs to convert to LTCs, or failing that to ordinary companies, would not only impose significant compliance costs on those businesses but would also not be practical as the LTC requirements might not be suitable for many QCs.

This means that while no new QCs can be created, existing QCs can continue until they are either liquidated, elect out of the QC regime or fail to meet the QC eligibility criteria. In effect, this provides the grandparented QCs with some degree of permanent tax advantage, due primarily to the opportunity for tax deferral on income through the taxing of the income in the first instance at the company rate, which is often lower than the top personal rate, or the favourable treatment of capital gains relative to ordinary companies.

The effective limitation on trading of QCs by ensuring that QC status is lost if there is a change in control of the company, supports the 2010 decision to grandparent QCs. This outcome ensures that existing QC owners are able to make some shareholder changes without sacrificing QC status while preventing the current owners from trading any tax advantage.

Key features

A change of control will be measured using a continuity test. The new shareholder continuity limitation in section HA 6 of the Income Tax Act requires a "minimum continuity interest" of at least 50 percent for the "QC continuity period". The continuity period will extend from the date of Royal assent (30 March 2017) to the last day in the relevant income year. The "minimum QC interest" is defined to mean the lowest voting interest or market value interest during the continuity period.

A breach of this requirement will trigger the loss of QC status under the standard QC rules.

To ease compliance, the continuity test will apply prospectively to changes in shareholding from the date of enactment (30 March 2017).

Exceptions

For the purposes of the shareholder continuity measurement, changes to shareholding resulting from property relationship settlements or the death of a shareholder will be ignored when measuring a change of control.

In addition, transfers between close relatives are ignored when measuring a change in control. The amendments achieve this by treating shares that have been transferred to a close relative as being held by a single notional person.

For this purpose "close relative" is defined as a spouse, civil union partner or de facto partner of the person or a person who is within the second degree of relationship to the person.

Example

A QC has two shareholders: Tara, who holds 40 percent of the shares in the QC and Uri, who holds 60 percent of the shares in the QC.

Uri transfers his shares in the QC to Velma, his daughter. Velma then transfers half of her 60 percent shareholding to Walter, her spouse.

As the transfers between Uri, Velma and Walter have all been between close relatives they are treated as being held by a single notional person and so will not affect the QC continuity test.

Application date

The amendments apply for the 2017–18 and later income years.

Ex-qualifying companies and inter-corporate dividend exemption

Sections CW 14 and HA 17 of the Income Tax Act 2007 and sections HG 10 and HG 10B of the Income Tax Act 2004

An amendment has been made to limit the scope of section CW 10, which prevents companies that were once qualifying companies from utilising the inter-corporate dividend exemption.

Background

When the qualifying company regime was being considered, the Consultative Committee on the Taxation of Income from Capital (the Valabh Committee) recommended that qualifying companies not be able to utilise the inter-corporate dividend exemption. This was intended to prevent ordinary companies from providing exempt dividends to qualifying companies, which could then be distributed tax-free to shareholders due to qualifying companies being able to pay un-imputed dividends tax free.

The Valabh Committee also recommended that companies that had previously been qualifying companies should similarly not be able to utilise the inter-corporate dividend exemption.

This was because there is a potential avoidance risk through a QC creating capital gains through revaluing the shares they hold in a non-qualifying company. These capital gains can be passed to shareholders as exempt dividends and funded by a loan back to the QC. If the QC then converts to an ordinary company, the company can, if the inter-corporate dividend exemption is available, receive an exempt dividend from other companies in a wholly owned group, which could be used to repay the loan from the shareholder without a tax cost.

However, this rule extends too far and prevents the use of the inter-corporate dividend exemption in circumstances when the avoidance risks are minimal. As a result, amendments have been made to limit the scope of the rule.

Key features

Amendments to sections CW 14 and HA 16 have been made so that the inter-corporate dividend exemption is available to companies that have previously been qualifying companies when either:

- the dividend is derived at least seven years after the company ceased to be a qualifying company; or
- the company never paid an un-imputed dividend while it was a qualifying company.

The amendment is retrospective to the 2005–06 income year. To achieve this, corresponding amendments to sections HG 10 and HG 10B of the Income Tax Act 2004 have been made.

Application date

The amendment applies for the 2005–06 and later income years.

Tainted capital gains

Sections CD 44 and CZ 9B of the Income Tax Act 2007

The scope of the "tainted capital gains" rule is being narrowed to address a previous overreach of the rule, and make it much more targeted.

Specifically, the rule will only apply to asset sales between companies that have at least 85 percent common ownership, with the original owners still retaining at least 85 percent interest in the asset at the time of liquidation. Previously, the rule applied to any associated party transactions.

Background

Capital gains derived at the company level cannot be distributed tax-free by ordinary companies, except upon liquidation. Previously the tainted capital gains rule (in section CD 44(10B) of the Income Tax Act) taints a capital profit if it was realised through a sale of a capital asset to an associated person, making the gain taxable when distributed to shareholders in a liquidation. There was one exception to the rule which applies to gains derived by a close company (as defined in section YA 1) that arise during the course of liquidation.

The policy rationale for the previous rule was that sales of assets between associated persons (for example, sales within a group of companies) could be for the purposes of creating additional amounts of capital reserves for tax-free distribution, rather than for general commercial reasons. The concern was that this would allow a company to distribute "capital profits" tax-free in lieu of dividends, which would have been taxable.

The rule had its origins in the mid-1980s when some companies were selling assets to associated companies to generate capital gains that they could at the time use to pay out tax-free dividends. Major changes to tax settings since then, in particular the introduction of the imputation regime and a comprehensive definition of what is a "dividend", made the rule less relevant.

In practice, the previous rule could capture genuine transactions when the sale was not tax driven – for example, the transfer of an asset as part of a genuine commercial restructure. The restriction, therefore, extended beyond its intended ambit and applied to gains made on sales to any associated party, not just an associated company. Companies could often be inadvertently caught by the rule, resulting in their being unable to be subsequently liquidated without a tax impost.

The rule still has a role in the case of sales between companies that have significant commonality of ownership, where it provides protection against arrangements that are in effect in lieu of a taxable dividend. The rule has, therefore, been confined to such instances.

Key features

The previous rule and exception relating to capital gains (and capital losses) made on asset sales between associated companies (section CD 44(10B) and (10C)) have been replaced with a rule that measures commonality of ownership interest both at the time the asset is sold and at the time of the liquidation distribution.

A capital gain or capital loss amount will not arise (in other words, the amount is tainted) if:

(i) at the time of disposal, a group of persons holds, in relation to the seller company (company A) and the buyer company, common voting interests or common market value interests of at least 85 percent; and

(ii) on the liquidation of company A, the company that owns the asset is company A or, if it is not company A, the percentage given by the following formula is 85 percent or more:

commonality interest × ownership interest

where:

commonality interest is the percentage of common holding by a group of persons, for the owning company and company A, of common voting interests or common market value interests (if they are greater than the common voting interests);

ownership interest is the percentage of ownership of the asset, by market value, for the owning company.

For example, an asset of a company (company A) may be sold to another company (company B) in the same wholly owned group for a capital gain and at a later stage be on-sold to a non-associated company for a further capital gain, with both companies being liquidated. Both gains will be non-taxable as the outcome of the series of transactions is that by the time of the liquidation distribution the asset has been sold to a company that has no common ownership with companies A and B.

If the owner at the time of liquidation is a non-corporate, (ii) above is not relevant (as that leg of the test requires some portion of the asset to be owned by a company). The gain or loss will, therefore, not be tainted.

The proposed threshold is set at 85 percent because a change of ownership to an unrelated third party of more than 15 percent provides sufficient assurance that the transaction is genuine and involves a real transfer of the underlying assets rather than, say being in lieu of a dividend.

Application date

The amendments come into force on the date of enactment and apply to distributions made on or after that date.

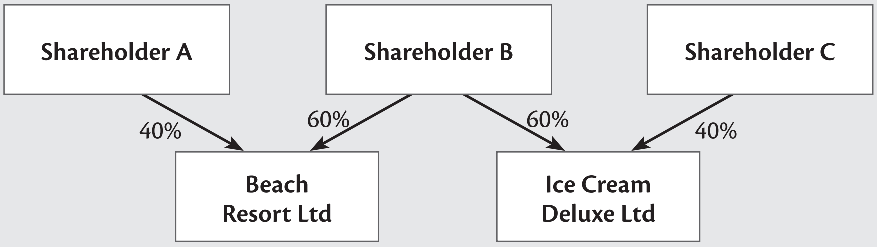
Detailed analysis

Gains prior to date of enactment

The new rules apply to liquidations of a company from the date of enactment. This means the new formula applies to capital gain or loss amounts that were made prior to the date of enactment as long as the liquidation occurred after the date of enactment.

This includes gains made between 1988 and 2010 to which the "related persons" test previously applied. To achieve this, section CZ 9B, which contains the related persons test, and section CD 44(14B), which cross-refers to section CZ 9B, have been repealed.

Example



Beach Resort Ltd and Ice Cream Deluxe Ltd are associates due to having a shareholder with voting interests in each company of 60%. The remaining 40% of shareholdings are held by different persons for each company.

On 1 May 2005, Ice Cream Deluxe Ltd sold its ice cream cart to Beach Resort Ltd with Ice Cream Deluxe Ltd making a capital gain of $10,000 on the transaction.

On 1 September 2018, Ice Cream Deluxe Ltd is liquidated. The $10,000 capital gain is not tainted as no group of persons hold common voting interests of 85% or more in both companies.

Timing of liquidation

The second part of the test looks at the ownership of the asset "on the liquidation of company A". The timing of this test occurs when an amount is distributed on the liquidation of the company.

Asset that has ceased to exist

If an asset ceases to exist on the liquidation, any capital gains or losses from the asset will not be tainted. This is because, at the time, no company owns the asset and so the second limb of the test above will not be met (company A will not own the asset and the ownership interest will be 0%).

Example

Company A acquires a boat for $400,000. Company A sells the boat to Company B for $500,000. Company A and Company B have common voting interests of 90%.

The boat sinks and Company B has to write off the asset as it is neither salvageable nor insured. Company A and Company B subsequently liquidate.

The $100,000 capital gain for Company A and the $500,000 capital loss for Company B will not be tainted. This is because on the liquidation, neither Company A nor Company B own the asset and the ownership interest for the asset is 0% as no one owns it.

Application date

The amendments came into force on the date of enactment, being 30 March 2017 and apply to distributions made on or after that date.

RWT on dividends

Sections CD 39, RD 36, RE 2, RE 13, RE 14 and RE 14B of the Income Tax Act 2007

Amendments have been made to deal with the over-taxation of certain dividends under the resident withholding tax (RWT) rules:

- The first change allows a company to opt out of deducting RWT from a fully imputed dividend paid to corporate shareholders.
- The second change provides a new formula for determining the RWT obligation when cash and non-cash dividends are paid contemporaneously.

A third amendment deals with an unintended restriction, because of the need to deduct RWT, on the rule which allows a dividend to be backdated to clear a shareholder's current account.

Background

RWT on dividends between companies

The payment of passive income, such as dividends and interest to resident recipients is subject to an obligation to account for RWT, which is withheld by the company at the time of payment and paid to Inland Revenue in the month following payment. For dividends, a flat rate of 33% applies (less any imputation credits). For interest, the RWT rate varies according to the recipient's personal marginal tax rate.

As a result of the lowering of the company tax rate to 28%,[3] even when a company pays a fully imputed dividend the dividend is still subject to an additional 5% RWT. For dividends paid to corporate shareholders (who will be subject to the company tax rate of 28%) this obligation to withhold RWT resulted in an initial over-taxation of these dividends.[4] Before the amendment, this over-taxation could give rise to additional compliance costs for both the paying company, which had to account for the additional RWT to Inland Revenue, and the recipient company, which was required to seek a refund when the RWT credit could not be used.

RWT on concurrent cash and non-cash dividends

When a company pays a non-cash dividend, such as a taxable bonus issue, the dividend is still subject to RWT. The non-cash dividend is required to be grossed up because the RWT cannot practically be withheld from the non-cash amount.

When a company pays a non-cash dividend concurrently with a cash dividend, both dividends are subject to RWT. Before the amendments, the two dividends were treated as separate dividends, meaning that the non-cash dividend was still subject to the gross-up even when the concurrent cash dividend was sufficient to cover the RWT obligation on both dividends. This could result in the RWT obligation across both dividends being higher than it should be.

RWT impact on backdating a dividend

Under the dividend rules, shareholders who have overdrawn current accounts at year end are treated as having received a deemed dividend based on the interest they would have had to pay if the overdrawn account had been a loan.

To simplify matters for taxpayers, the rules in sections CD 39(5) and RD 36(2)(b) were introduced, which allow a company to pay a backdated fully imputed dividend to clear, or at least reduce, an overdrawn current account. For dividends to qualify for backdating there must be no further tax owing.

The application of these rules was unintentionally limited as a result of the company tax rate changes. They technically did not work, as a dividend could only be backdated if there is no RWT obligation on the dividend and, in practice, any dividend will have a RWT obligation, even a fully imputed dividend (which had a 5% RWT obligation).

Key features

RWT on dividends between companies

An amendment has been made which limits the definition of "resident passive income" in section RE 2(5) to exclude fully imputed dividends paid to a corporate shareholder if the paying company chooses to exclude the dividend from the definition.

In effect this allows a company to opt out of withholding RWT on a fully imputed dividend paid to another company. This amendment reflects the fact that the obligation to withhold RWT on a fully imputed dividend paid to another company over-taxes the dividend.

[3] This was as a result of two tax cuts – from 33% to 30% from the 2008–09 income year and to 28% from the 2011–12 income year.

[4] The exception is if the two companies are part of the same wholly owned group, in which case the dividend is exempt from tax, or the recipient company holds a certificate of exemption from RWT.

The ability not to withhold has been made optional because for some paying companies (particularly those that are widely held) an outright requirement not to withhold RWT on fully imputed dividends may raise compliance costs. This is because they will need first to establish which shareholders are corporates and those that are not, and differentiate between these two groups within their systems.

RWT on concurrent cash and non-cash dividends

To deal with the previous potential over-taxation of cash and non-cash dividends paid contemporaneously, new section RE 14B streamlines the RWT obligations by treating the two dividends as a single dividend. The amendment introduces a new formula to calculate the amount of RWT owing on the dividends, which applies only if the cash dividend is equal to or greater than the amount of RWT payable under the formula.

Consequently amendments have also been made to sections RE 13 (Dividends other than non-cash dividends) and RE 14 (Non-cash dividends other than certain non-share issues).

RWT impact on backdating a dividend

Amendments to section CD 39(9) and RD 26(2)(b) have been made to ensure the rules work as intended. The intention is to allow for a dividend that had no further tax owing (that is, it is fully imputed) to be backdated, to expunge, or at least reduce, an overdrawn current account balance. This avoids or limits the deemed dividend arising and reduces compliance costs. However, a previous requirement was that there had to be no RWT obligation.

Taxpayers continued to use the rule but due to an oversight at the time the company tax rate was changed, it technically did not work given the need to deduct RWT. The amendment provides certainty by clarifying that the rule should apply to dividends that are fully imputed, irrespective of any RWT obligation.

Application dates

The first two amendments to enable companies to opt out of deducting RWT from fully imputed dividends paid to corporate shareholders and providing a new formula for determining the RWT obligation when cash and non-cash dividends are paid contemporaneously, apply from the date of enactment, being 30 March 2017.

The third amendment to allow dividends to be backdated applies from 1 April 2008 for the 2008–09 and subsequent income years.

Detailed analysis

Sections RE 13 and RE 14 calculate the RWT required to be withheld on cash and non-cash dividend respectively. Previously, when cash and non-cash dividends were paid contemporaneously, with the objective of the cash dividend being used to account for the RWT owing on the non-cash dividend, there was potential over-taxation because the two dividends are treated separately under these two sections.

New section RE 14B provides the payer with the option of combining cash and non-cash dividend payments and accounting for RWT as though they were a single dividend. The new section only applies when the cash dividend alone is sufficient to cover the total RWT owing, meaning that RWT will be paid by deduction rather than gross-up, and the payer has elected for the section to apply.

The amount of RWT that the payer must withhold is calculated using the following formula:

(tax rate × (dividends + tax paid or credit attached)) − tax paid or credit attached

where:

tax rate is the basic rate set out in schedule 1, part D, clause 5 (Basic tax rates: income tax, ESCT, RSCT, RWT, and attributed fringe benefits);

dividends is the total amount of the cash dividend and the non-cash dividend paid before the amount of tax is determined;

tax paid or credit attached is the total of the following amounts:

(i) if a dividend is paid in relation to shares issued by an ICA company, the total amount of imputation credits attached to the dividends;

(ii) if a dividend is paid in relation to shares issued by a company not resident in New Zealand, the amount of foreign withholding tax paid or payable on the total amount of the dividends.

To ensure there is no overlap of the rules, neither section RE 13 nor section RE 14 will apply to the dividends if the payer chooses to apply section RE 14B.

Amount of cash dividend required to satisfy the RWT liability

If a taxpayer provides a non-cash dividend and wishes to provide a cash dividend simply to satisfy the RWT liability on the non-cash dividend then the following formula provides how much cash dividend is required:

cash dividend = 0.4925 non-cash dividend – tax paid or credit attached*

Example

Co. X wishes to provide a non-cash dividend of $360. The non-cash dividend has imputation credits of $140 attached. Co. X wishes to provide a cash dividend solely to satisfy the RWT liability.

*cash dividend = 0.4925 * 360 – 140 = $37.30*

If Co. X provides a cash dividend of $37.30, the RWT payable is also $37.30.

PAYE on shareholder-employee salaries

Sections RD 3, RD 3B, RD 3C and YA 1 of the Income Tax Act 2007

An amendment has been made so that shareholder-employees of close companies who receive both regular salary or wages throughout the year and variable amounts of other employment income are able to elect to split their income so that the base salary is subject to PAYE and the variable amount is paid out before tax.

Background

Shareholder-employees of close companies often do not derive regular amounts of salary or wages, or do not get paid in regular periods throughout the income year. For smaller companies, the remuneration of shareholder-employees also often depends on the performance of the business and, therefore, the annual salary will not be known until well after year end. This can make compliance with the PAYE rules difficult because the rules are designed for circumstances when employees' salaries are known at the start of the income year and payments are made regularly (monthly, fortnightly or weekly) throughout the year.

To alleviate this problem, the previous rules allowed for shareholder-employees who do not derive regular amounts of salary or wages or who do not get paid for regular periods, to treat all amounts of income they receive through the year as not subject to PAYE, subject to certain conditions (see section RD 3). As a result, the amounts received would be taxable in the employee's tax return and could give rise to provisional tax obligations.

The previous rules may not have adequately relieved the compliance costs incurred by shareholder-employees and may not have suited the myriad of shareholder-employee circumstances, when paying a combination of PAYE and provisional tax might have been preferable. There was no option to pay a combination of PAYE and provisional tax; the rule was all or nothing.

Key features

New section RD 3C allows for a shareholder-employee of a close company to choose to split their earnings so that the base salary is subject to PAYE and the variable amount is paid out pre-tax, and is therefore likely to be subject to provisional tax instead.

To be able to treat any payments as not subject to PAYE under these rules, the shareholder-employee must meet one of the following three requirements:

- the shareholder employee does not derive salary and wages of a regular amount for regular pay periods of one month or less; or
- less than 66 percent of their annual gross income is salary or wages; or
- an amount is paid to them as income that may later be allocated to them as an employee for the income year.

If the shareholder-employee does not meet these requirements, the full amount of payments to them are subject to PAYE.

This amendment allows additional flexibility for shareholder-employees who may be unduly constrained by the current rules.

To ensure that the ability to switch between provisional tax and the PAYE system is not used inappropriately, there are rules to prevent taxpayers "flip flopping" between the options. These rules provide that:

- if a taxpayer has previously elected to use either the provisional tax method (section RD 3B) or the split provisional tax and PAYE method (section RD 3C) for their shareholder salary payments; and
- the taxpayer then elected a different treatment for their shareholder salary payments; then
- the taxpayer cannot elect to use either of the provisional tax methods for three income years.

Example

Steve is a shareholder employee of Steve Co. In the 2018–19 income year, Steve receives a shareholder salary of $50,000 which he elects to have treated under the provisional tax rules.

In the 2019–20 income year, Steve receives shareholder salary of $50,000 which he elects to have treated under the PAYE rules.

As Steve has elected out of the section RD 3B provisional tax option, Steve cannot elect to use the section RD 3B and RD 3C provisional tax options until the 2023–24 income year.

Application date

The amendments apply for the 2017–18 and later income years.

NRWT: RELATED PARTY AND BRANCH LENDING

The Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 introduced a number of changes to the taxation of interest payments to non-residents.

Background

New Zealand imposes non-resident withholding tax (NRWT) on New Zealand-sourced interest paid to foreign lenders. The rate is 15%, usually reduced to 10% if the lender is resident in a country with which New Zealand has a double tax agreement. An obligation to withhold falls on the New Zealand borrower. NRWT is still a tax on the foreign investor and they will usually get a credit for the New Zealand tax against the tax they pay on the interest in their home jurisdiction.

A New Zealand borrower can elect to pay the 2% approved issuer levy (AIL) instead of withholding NRWT but only if they are borrowing from an unrelated lender – such as a foreign bank. Foreign lenders cannot claim a credit for AIL against home jurisdiction tax. This means it can be more tax-efficient for NRWT to be paid rather than AIL.

Broadly speaking, there are two parts to the reform package:

- changes to the NRWT rules generally to bring the rules dealing with timing and quantification of income subject to NRWT in line with the FA rules; and
- changes to the NRWT/AIL rules, which particularly affect branch structures.

The NRWT reform is about correcting anomalies in the rules to level the playing field for taxpayers to whom the NRWT rules apply (or are intended to apply). The changes focus on ensuring that an NRWT liability arises on interest on related party debt at approximately the same time that an income tax deduction is available to the borrower for that interest. Under the previous rules a number of structures delayed or removed the liability for NRWT or replaced it with AIL. Changes have also been introduced for related party lending by New Zealand banks.

The branch changes level the playing field between certain borrowers who can step around AIL and NRWT by operating an onshore or offshore branch, and other borrowers who cannot and are therefore subject to NRWT or AIL on interest paid to non-resident lenders. Much of the interest on funding that flows through a branch structure is ultimately paid to unrelated parties and will become subject to AIL although NRWT will continue to be available. One kind of structure involving related party lending and onshore branches is now subject to NRWT.

Proposals for these changes were consulted on in an officials' issues paper, *NRWT: Related party and branch lending*, released in May 2015. Twenty-two submissions were received. Separate targeted consultation was subsequently held with the banking sector on the onshore branch notional interest proposals. Feedback from both consultations helped to shape the NRWT and AIL amendments in the new legislation, which was introduced in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill on 3 May 2016.

Further refinements to the proposals were recommended by the Finance and Expenditure Committee in response to submissions made at the select committee stage of the Bill. The main recommendations included:

- a number of drafting changes to ensure the rules operate as intended and to assist interpretation;
- requiring the non-resident financial arrangement income (NRFAI) amount to be calculated under another spreading method if the borrower uses the fair value method or the market valuation method;
- removing amounts from NRFAI that have not and will not be received by the borrower;
- removing lending by a non-resident through their New Zealand branch from the scope of the NRFAI rules;

- adding an intention test to the back-to-back loan provision;
- clarifying and reducing the obligations of a direct lender that is party to a back-to-back loan;
- clarifying that the back-to-back loan provisions apply only when the debt is not already between related parties;
- removing interest amounts that are already subject to AIL from the notional loan rules;
- moving the date of the notional interest payment from the end of the income year to the end of the third month following the income year;
- extending the five-year grandparenting of the onshore branch changes to certain securitisation vehicles that raise funding from third parties to provide to other third parties; and
- removing the AIL registration proposals.

Interest on related party lending

In broad terms, the amendments address "holes" in the NRWT base to ensure that the tax applies evenly to economically similar and easily substitutable transactions. They do not attempt to expand the NRWT base beyond its target of associated party interest, or interest which is logically indistinguishable from associated party interest.

Previously, differences in the timing of payments made under a loan from a non-resident parent company to its New Zealand subsidiary resulted in very different NRWT outcomes. For example, on an ordinary interest-paying loan, NRWT is payable every time interest is paid. However, for a zero-coupon bond, NRWT was not payable until the bond matured. This difference in the NRWT treatment was not mirrored in the income tax treatment for the borrower. The deduction for the borrower in an interest-bearing loan is similar to the deduction for the borrower in a zero-coupon bond. The deferral of the NRWT impost compared with the income tax benefit provided a significant timing benefit.

Another issue arose with the boundary between NRWT and AIL. While AIL is unavailable when the New Zealand borrower is controlled by the non-resident lender, it was available when a group of lenders were acting together and controlled the New Zealand borrower (typically a joint venture or private equity situations). This situation is difficult to distinguish economically from the case of a single non-resident controller – the group of shareholders are able to act as if they were a single controlling shareholder – yet the availability of AIL differed.

The effect of these (and certain other) issues was that non-resident investors who were able to take advantage of them faced a lower effective tax rate in New Zealand than other investors. This was not appropriate.

To address these issues the following changes have been introduced:

- NRWT must be paid at approximately the same time as interest is deducted by the New Zealand borrower, if the borrower and lender are associated. This means that the NRWT consequence of economically similar loan structures is similar; and
- the boundary between NRWT and AIL has been adjusted, so AIL is no longer available when a third party is interposed into what would otherwise be a related party loan or where a group of shareholders are acting together as one to control and fund the New Zealand borrower.

These changes bring the NRWT treatment of substantially similar transactions into line.

Application date

The amendments apply to existing arrangements on and after the first day of the borrower's income year that starts after the date of enactment, being 30 March 2017.

For all other arrangements the amendments came into force on the date of enactment.

As the Bill was enacted on 30 March 2017 the rules will apply to arrangements entered into after that date. For a taxpayer with a balance date between 30 March 2017 and 30 September 2017, the rules will apply to existing arrangements from the start of the 2017–18 year.

For taxpayers with a balance date between 1 October 2017 and 29 March 2018, the rules will apply to existing arrangements from the start of the 2018–19 year.

The changes to allow registered banks to pay AIL on associated party funding applied from the date of enactment.

Key features

Broadening arrangements giving rise to non-resident passive income

Non-resident passive income (NRPI) only arises when there is "money lent" (leaving aside dividends and royalties). Although the definition of "money lent" is broad, it did not apply in all situations when there was funding provided under a financial arrangement. This could result in a New Zealand borrower incurring financial arrangement expenditure when the non-resident lender had no NRPI.

The definition of "money lent" has been extended to include any amount provided to a New Zealand resident (or New Zealand branch of a non-resident) by an associated non-resident under a financial arrangement that provides funding to the resident, and under which the resident incurs financial arrangement expenditure. As "money lent" is a term used in other places in the Income Tax Act 2007, this change is limited to the NRWT rules.

Reducing quantum mismatches between NRPI and financial arrangement expenditure

To reduce mismatches between the NRWT and financial arrangement rules, the definition of "interest" has been extended to include a payment (whether of money or money's worth) received by a non-resident from an associated New Zealand resident (or New Zealand branch of a non-resident), to the extent that the payment gives rise to expenditure to the borrower under the financial arrangement rules.

Related party debt

"Related party debt" is a new defined term. It covers all financial arrangements where a non-resident provides funds to an associated New Zealand resident (or New Zealand branch of an associated non-resident) and the borrower is allowed a deduction under the financial arrangement rules. To prevent this being structured around, it also includes funding provided through an indirect associated funding arrangement or by a member of a non-resident owning body – these terms are explained below.

A consequence of this definition is that money lent to exempt borrowers (such as charities) does not meet the "related party debt" definition. This is appropriate as no asymmetry can arise between income tax deductions and a lack of NRWT when there is no income tax deduction. Exempt borrowers continue to be required to withhold NRWT under payment rules that existed before the amendments, provided the other requirements are met.

Members of a banking group that are registered by the Reserve Bank are also carved out of having related party debt by section RF 12H(2). This is because amendments to section RF 12(1)(a)(ii) recognise that interest payments by New Zealand banks are directly or indirectly equivalent to third-party debt on which AIL can be paid. Although NRWT will continue to be available on interest payments by banks this can be eliminated by paying AIL instead and AIL does not apply on an accrual basis.

Arrangements that provide funds

For an arrangement to meet the definition of "related-party debt" one of the criteria it must satisfy, in section RF 12H(1)(a), is that the arrangement provides funds to another person. The purpose of this criterion is that NRWT on interest has historically applied to debt instruments and the amendments are intended to cover arrangements that are economically similar to debt. An arrangement that provides funds is intended to be narrower in scope than a financial arrangement.

The concept of a financial arrangement that "provides funds" already exists in a number of places in the Income Tax Act 2007.[5] Due to the wide variety of financial arrangements available it is not possible to provide an exhaustive list of particular arrangements that will or will not provide funding. However, the inclusion of this term in the NRWT rules is not intended to alter its interpretation as it previously applied.

When the thin capitalisation rules were introduced in 1995, commentary was provided on what the term "provides funds" meant. For reference these are included below:

Tax Information Bulletin Volume 7, Number 11, March 1996:

> The term "provides funds" is not defined in the Act. It is intended to convey the broad concept that only arrangements that provide capital to the issuer should be included in the thin capitalisation regime.

Comment from officials in the Officials' report on the Taxation (International Tax) Bill 1995:

> However, it is recognised that certain financial instruments covered by the financial arrangement definition do not give rise to capital being made available to the New Zealand entity. These include certain hedging or speculative instruments, such as some foreign exchange transactions and certain swaps.

[5] See, for example, sections EX 20B and EX 20C in the CFC rules and sections FE 5, FE 6B, FE 13, FE 14, FE 15 and FE 18 in the thin capitalisation rules.

NEW LEGISLATION

Tax Education Office Newsletter No 121, July 1996:

> Linking the concept of debt to the "financial arrangement" definition potentially encompasses instruments and arrangements which may have no resemblance to standard interest bearing debt, eg futures contracts, swaps and options. However, section FG 4(2) [of the Income Tax Act 1994] specifies that the financial arrangement must provide funds to the issuer in order to be categorised as debt under the regime. This requirement is intended to ensure that only arrangements which provide capital to the borrower should be included as debt.
>
> For example, swaps should be excluded from the definition of total debt, unless there is a real borrowing rather than simply a swap of interest or currency obligations. In the case of other financial derivatives, such as options and futures contracts, it is unlikely that such arrangements would fulfil the requirement of providing funds to the issuer.

Further to the examples provided above officials expect that a finance lease, which in substance is a loan, would generally provide funding whereas an operating lease would not. The examples above provide that a swap would not provide funds and this will generally be the case. One exception to this may be where the swap exchanges collateral which is available to the New Zealand resident; however, this would be very fact specific and would need to be considered on a case-by-case basis.

Calculating whether non-resident financial arrangement income arises

One of the principal concerns the amendments addressed is where interest payments (and therefore NRWT) significantly lagged accrued deductions. Although deductions can be accrued on a daily basis, interest is usually paid in arrears, frequently up to 12 months after the start of the interest period. These rules do not apply to arrangements when interest is accrued up to balance date but paid shortly thereafter; they are instead intended to cover more substantial deferrals.

To achieve this, taxpayers, for each related party debt are required to complete a deferral calculation, at the end of the second and subsequent years following issue of a financial arrangement, to determine whether non-resident financial arrangement income (NRFAI) arises.

Where the deferral calculation in section RF 2C(4) is satisfied, NRFAI does not arise and the related party debt continues to be taxed under the NRWT rules as they applied before the current amendments. The calculation that must be undertaken separately for each related party debt at the end of each income year is:

> *accumulated payments* ÷ *accumulated accruals* ≥ 90%

These terms are defined in section RF 2C(5) as:

> *accumulated payments* is the total interest paid since the financial arrangement became a related party debt until the due date for filing the NRWT return for the second month after the end of the income year.
>
> *accumulated accruals* is the total expenditure the borrower incurs (excluding the effect of foreign exchange fluctuations) while the arrangement is a related party debt until the end of the year preceding the income year.

The period for the two variables is different, with "accumulated payments" covering payments made up to and somewhat beyond the end of the most recent completed income year while "accumulated accruals" excludes the most recently completed year. There are two reasons for this difference:

- This approach ensures NRFAI does not arise simply because interest is paid annually in arrears.
- "Accumulated payments" only requires knowing what interest has been paid whereas "accumulated accruals" requires a calculation under the financial arrangement rules, which might often not be made until shortly before the income tax return is filed. Using "accumulated accruals", excluding the current year means the majority of the necessary calculations will have already been completed in the ordinary course of business (that is, whether or not these rules were introduced).

Applying a 90% threshold rather than a 100% threshold provides an additional buffer, so that the deferral calculation is not triggered when the majority of interest payments are paid on a 12-month or less deferral basis, but there is a limited amount of accrued interest – for example, when a bond is issued at a slight discount. This 90% discount also partially equalises the effect on arrangements that are entered into at different points prior to a balance date and before the first interest payment is made.

Once NRFAI arises in a year, section RF 2C (2)(a) requires NRWT to continue to apply on an accrual basis so long as the financial arrangement is related party debt. This means it will not be necessary for a taxpayer to repeat the above deferral calculation once the 90% threshold has been breached.

Record keeping requirements for NRFAI calculations

There is no prescribed form for the deferral calculation. Taxpayers will, however, be expected to complete and retain sufficient records to support their tax position. As the deferral calculation is only important in determining whether NRFAI has been derived, rather than the specific value of that calculation, the record keeping requirements should be broadly proportional to the significance of the calculation. For example, a related party debt that had regular interest payments equal to the interest accrued since the previous interest payment would not be expected to be near the 90% threshold so the records to support this would not need to be particularly detailed. Likewise a related party debt that did not have any interest payments would be treated as over 90% at the first NRFAI due date but would be less than 90% at the second NRFAI due date so again minimal records would be required. In contrast, a taxpayer that completed a deferral calculation showing that the result of the formula was 92% would need to maintain sufficient records to satisfy the Commissioner, if requested, that the 92% figure was accurate and should not instead be below 90%.

Related party de minimis threshold

If a New Zealand borrower has only a small amount of related party financial arrangement expenditure, the amount of the NRWT deferral, compared with income tax deductions, may not be sufficiently large to justify the additional compliance costs of having to apply the NRFAI rules.

Sections RF 2C(2)(b)(i) and RF 2C (3) carve out a borrower (and their related party lenders) from applying the NRFAI rules, except in relation to arrangements already subject to NRFAI, if their expenditure on related party debt in the previous year is less than $40,000. Unlike the rest of the NRFAI rules, to minimise compliance costs, this threshold includes foreign exchange movements on those financial arrangements so that a separate calculation is not required to be undertaken. The threshold also includes expenditure incurred by entities with a common ownership (66%) of the borrower, to prevent taxpayers avoiding the NRFAI rules by borrowing through multiple entities.

Timing of calculations and payment

The above deferral calculation should be completed as part of the preparation of the NRWT return for the second month after the borrower's balance date. This NRWT return is due on the 20th of the third month after balance date. This date is defined in section RF 2C(7) as the "NRFAI due date". Once NRFAI arises for a year, section RF 12E(1) deems it to be paid to the non-resident recipient on the final day of that second month. This determines the dates when the NRFAI must be included in a return and paid.

The exception to this timing is when a related party debt ceases during a year (the cessation date) in which case the income arising from the start of that year until the cessation date is treated by section RF 12E(2) as paid on the final day of the second month following the cessation date.

Foreign currency conversions

For arrangements denominated in foreign currency the income calculations are completed in that currency before any income subject to NRWT is converted into New Zealand dollars for the purpose of calculating the tax payable. The effect of this order is that foreign exchange movements are generally excluded[6] from NRFAI calculations.

The general rules for currency conversions in subpart YF apply for the NRWT rules. Section YF 1(2) converts foreign currency into New Zealand dollars by applying the close of trading spot exchange rate on the date at which the amount is required to be measured or calculated.

Section RF 12E provides that NRFAI is paid on the last day of the second month after a terminating event or the last day of the second month following the New Zealand borrower's balance date. This is the date that section YF 1(2) requires the NRFAI amount to be converted into New Zealand dollars.

Voluntary election into NRFAI

The one-year deferral test above means that NRFAI cannot arise for an arrangement, including one with no regular interest payments, before the end of the second year of the arrangement. However, in some cases (for example, a zero coupon bond) it is self-evident that the instrument will give rise to NRFAI and a borrower may find it easier to apply NRFAI treatment from the inception of the arrangement. Section RF 12G allows taxpayers to elect to apply NRFAI from the first year the arrangement becomes a related party debt.

Taxpayers can also elect to disregard the application of the related party de minimis threshold. One reason they may choose to do this is when they expect to be above the de minimis threshold in future years.

[6] The exception to this is the de minimis test in section RF 2C(3), which includes foreign exchange movements to minimise compliance costs for borrowers determining whether the de minimis applies.

First-year adjustment

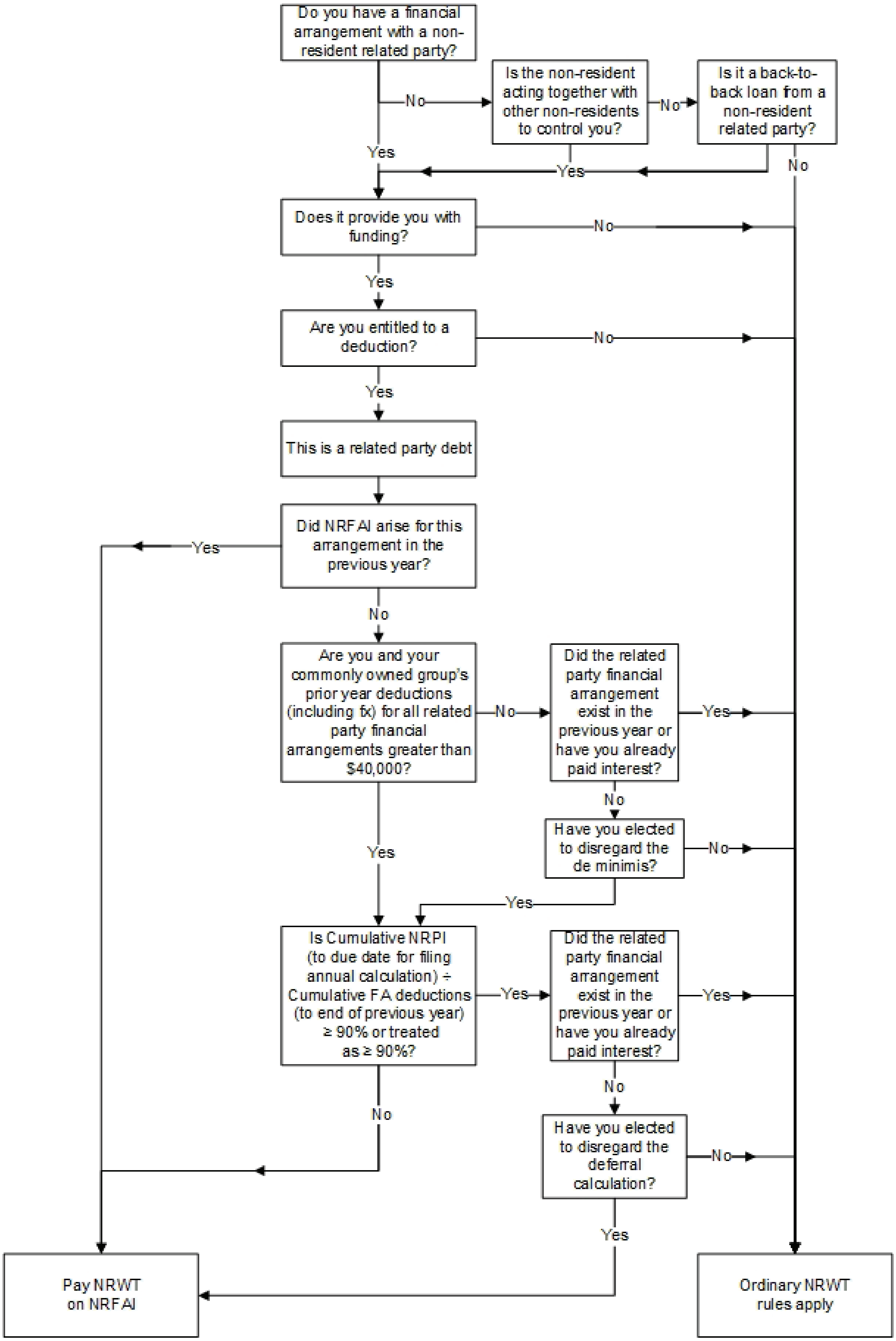
The first year that a non-resident derives NRFAI on a related party debt, the borrower will need to calculate the non-resident's income from the debt for that year using the financial arrangement rules. The method will be the same as the borrower applies to calculate their income tax deductions unless they apply the fair value or market valuation methods in which case another method must be chosen. The non-resident is also treated as deriving an additional amount of income, under section RF 12F, which removes the income deferral from that debt for all prior years, including any years the arrangement existed before enactment of the amendments.

Taxpayers who wish to avoid paying NRWT on pre-enactment deferral can prevent this by making sufficient interest payments after the enactment of the amendments so that NRFAI does not arise. This distinction arises as the deferral calculation covers only the period back to the day the arrangement became related party debt. Arrangements entered into before application of the new rules can only be related party debt from the first day of the first income year after that application date. Whereas the NRFAI calculation formula goes back to the date the person became party to the arrangement.

Amounts not received by the lender

The financial arrangement rules are intended to be sufficiently comprehensive that they include expenditure that will never be received by the lender – for example, when a borrower pays fees to a third party. As the NRFAI rules are designed to tax the lender on income they will receive, any amounts that will not be paid to them are excluded. This exclusion does not include amounts that are not received for other reasons, such as default by the borrower.

Figure 1: Do I need to pay NRWT on NRFAI?



Examples

The following examples illustrate the main features of the new rules.

Example 1: Zero coupon bond

A Co has a 31 March balance date and issues a zero-coupon five-year bond with a face value of $1,000 to an associated non-resident on 1 August 2017. The bond is issued for $700. Deductions are calculated on a YTM basis with a 243/365ths apportionment between years.

#	Date	Event	Payments	Deductions	Deduction > payment	Cash NRWT	NRFAI NRWT
1	1 Aug 2017	Arrangement commences	−700				
2	31 Mar 2018	Balance date		34.46			
3	20 Jun 2018	NRFAI calculation date			N/A – First year		
4	31 Mar 2019	Balance date		54.31			
5	20 Jun 2019	NRFAI calculation date			0 ÷ 34.46 = 0% = NRFAI triggered		(34.36 + 54.31) × 10% − 0 = 8.87
6	31 Mar 2020	Balance date		58.32			
7	20 Jun 2020	NRFAI calculation date			Not required		5.83
8	31 Mar 2021	Balance date		62.63			
9	20 Jun 2021	NRFAI calculation date			Not required		6.26
10	31 Mar 2022	Balance date		67.27			
11	20 Jun 2022	NRFAI calculation date			Not required		6.72
12	30 Sep 2022	Maturity	1,000			0	
13	20 Dec 2022	Maturity NRFAI calculation					2.30
14	31 Mar 2023	Balance date		23.01			
	Total		**300**	**300**		**30**	

The balance date entries in #2, 4, 6, 8, 10 and 14 represent income tax deductions available for the return period ending on that date. These may not be calculated until after this date, though the requirement to calculate and pay provisional tax may mean that the company does in fact calculate them earlier than the balance date. The same also applies for the later examples.

The maturity NRFAI calculation in #13 is due on the due date for the NRWT return for the period two months after maturity even though the income tax deduction may not be calculated until sometime after balance date.

As this arrangement has no regular interest payments, A Co would be aware from the outset that NRFAI would eventually arise. Therefore, it may elect to apply NRFAI from the commencement date which would result in an NRWT payment of $3.45 at #3 and the NRWT payment at #5 reducing to $5.43. Although this would be cashflow negative it may reduce compliance costs.

Example 2: Interest paid less than interest accruing

B Co has a 31 March balance date and borrows NZ$1,000 from an associated non-resident on 2 April 2017. B Co will pay $60 of interest on 1 April each year and $1,300 upon maturity on 1 April 2022. Deductions are calculated on a YTM basis with a 364/365[ths] apportionment between years.

#	Date	Event	Payments	Deductions	Deduction > payment	Cash NRWT	NRFAI NRWT
1	2 Apr 2017	Arrangement commences	−1,000				
2	31 Mar 2018	Balance date		108.03			
3	1 Apr 2018	Coupon date	60			6	
4	20 Jun 2018	NRFAI calculation date			N/A – First year		
5	31 Mar 2019	Balance date		113.55			
6	1 Apr 2019	Coupon date	60			6	
7	20 Jun 2019	NRFAI calculation date			120 ÷ 108.03 = 111.1%		
8	31 Mar 2020	Balance date		119.35			
9	1 Apr 2020	Coupon date	60			6	
10	20 Jun 2020	NRFAI calculation date			180 ÷ 221.58 = 81.2% = NRFAI triggered		(108.03 + 113.55 + 119.35) × 10% – 18 = 16.09
11	31 Mar 2020	Balance date		125.78			
12	1 Apr 2021	Coupon date	60			Not required	
13	20 Jun 2021	NRFAI calculation date			Not required		12.58
14	31 Mar 2022	Balance date		132.91			
15	1 Apr 2022	Maturity	1,360			Not required	
16	20 Jun 2022	NRFAI calculation date			Not required		13.29
17	20 Jul 2022	Maturity NRFAI calculation					0.04
18	31 Mar 2023	Balance date		0.36			
	Total		**600**	**600**		**60**	

Although the interest payment at #9 is paid after the end of the March 2020 tax year, which is the first one NRFAI arises in, it is not expected the NRFAI 90% calculation will have been completed by this date as it is not yet due. This is the reason NRWT on a payments basis is still required; however credit is given for this in the 90% calculation.

NEW LEGISLATION

Example 3: Interest accruing but not credited to account

C Co has a 30 June balance date and a loan facility from an associated non-resident with an interest rate of 10% pa on the outstanding balance, payable at the demand of the lender. C Co draws down $1,000 from this facility on 1 July 2017. The lender demands annual interest payments of $100 for the first four years. The lender then stops demanding interest payments and the borrower does not credit them to the lender's account, although interest continues to accrue on an annually compounding basis. C Co calculates its expenditure from the facility under the IFRS financial reporting method.

#	Date	Event	Payments	Accrued interest	Deductions	Deduction > payment	Cash NRWT	NRFAI NRWT
1	1 Jul 2017	Facility draw-down	−1,000					
2	30 Jun 2018	Balance date	100		100		10	
3	20 Sep 2018	NRFAI calculation date				N/A – First year		
4	30 Jun 2019	Balance date	100		100		10	
5	20 Sep 2019	NRFAI calculation date				200 ÷ 100 = 200%		
6	30 Jun 2020	Balance date	100		100		10	
7	20 Sep 2020	NRFAI calculation date				300 ÷ 200 = 150%		
8	30 Jun 2021	Balance date	100		100		10	
9	20 Sep 2021	NRFAI calculation date				400 ÷ 300 = 133.3%		
10	30 Jun 2022	Balance date		100	100		0	
11	20 Sep 2022	NRFAI calculation date				400 ÷ 400 = 100%		
12	30 Jun 2023	Balance date		110	110		0	
13	20 Sep 2023	NRFAI calculation date				400 ÷ 510 = 78.4% = NRFAI triggered		610 × 10% − 40 = 21
14	30 Jun 2024	Balance date		121	121		Not required	
15	20 Sep 2024	NRFAI calculation date				Not required		12.10
	Total		**400 (excluding principal)**	**331**	**731**		**73.10**	

Even if C Co started paying interest again, this arrangement would stay in NRFAI. If it wanted to eliminate NRFAI it would need to repay the loan and replace it with a new one.

NEW LEGISLATION

Example 4: Arrangements entered into before application date

D Co has three separate loans from its non-resident parent. All three loans were for $2,000 and were drawn down on 1 April 2015 with no periodic interest payments and a single repayment amount of $2,500 on 31 March 2020. Due to its 31 March balance date, the NRFAI rules apply to D Co from 1 April 2017. On 1 April 2017 Loan 1 continues as originally intended, Loan 2 is repaid at the amount accrued on that date and replaced by a new loan that has annual interest payments and is repaid on 31 March 2020 and Loan 3 is restructured to have annual interest payments on 31 March each year for interest accrued after 1 April 2017 with the balance repaid upon maturity.

Loan 1

#	Date	Event	Payments	Deductions	Deduction > payment	Cash NRWT	NRFAI NRWT
1	1 Apr 2015	Arrangement commences	−2,000				
2	31 Mar 2016	Balance date	0	91.28		0	
3	31 Mar 2017	Balance date	0	95.45		0	
4	1 Apr 2017	NRFAI rules apply					
5	31 Mar 2018	Balance date	0	99.80		0	
6	20 Jun 2018	NRFAI calculation date			N/A – First year		
7	31 Mar 2019	Balance date	0	104.36			
8	20 Jun 2019	NRFAI calculation date			0 ÷ 99.80 = 0% = NRFAI triggered		(91.28 + 95.45 + 99.80 + 104.36) × 10% = 39.09
9	31 Mar 2020	Maturity	2,500	109.12		Not required	
10	20 Jun 2020	Maturity NRFAI calculation date			Not required		10.91
	Total		**500**	**500**			**50**

Loan 2 & new loan:

#	Date	Event	Payments	Deductions	Deduction > payment	Cash NRWT	NRFAI NRWT
1	1 Apr 2015	Arrangement commences	−2,000				
2	31 Mar 2016	Balance date	0	91.28		0	
3	31 Mar 2017	Balance date	0	95.45		0	
4	1 Apr 2017	NRFAI rules apply					
5	31 Mar 2018	Balance date	99.80	99.80		9.98	
6	20 Jun 2018	NRFAI calculation date			N/A – First year		
7	31 Mar 2019	Balance date	99.80	99.80		9.98	
8	20 Jun 2019	NRFAI calculation date			(99.80 + 99.80) ÷ 99.80 = 200%		
9	31 Mar 2020	Maturity new loan	2,286.52	99.80		9.98	
10	20 Jun 2020	Maturity NRFAI calculation date					
	Total		**486.13**	**486.13**		**48.61**	

NEW LEGISLATION

Loan 3:

#	Date	Event	Payments	Deductions	Deduction > payment	Cash NRWT	NRFAI NRWT
1	1 Apr 2015	Arrangement commences	-2,000				
2	31 Mar 2016	Balance date	0	91.28		0	
3	31 Mar 2017	Balance date	0	95.45		0	
4	1 Apr 2017	NRFAI rules apply					
5	31 Mar 2018	Balance date	99.80	99.80		9.98	
6	20 Jun 2018	NRFAI calculation date			N/A – First year		
7	31 Mar 2019	Balance date	99.80	99.80		9.98	
8	20 Jun 2019	NRFAI calculation date			(99.80 + 99.80) ÷ 99.80 = 200%		
9	31 Mar 2020	Maturity	2,286.52	99.80		28.65	
10	20 Jun 2020	Maturity NRFAI calculation date					
	Total		**486.13**	**486.13**		**48.61**	

Example 5: Foreign currency borrowing:

E Co has a 31 March balance date and borrows US$1,000 from an associated non-resident on 2 April 2017. E Co will pay US$60 of interest on 1 April each year and US$1,300 upon maturity on 1 April 2022. Deductions are calculated on a YTM basis with a 364/365ths apportionment between years.

Assume the exchange rates shown in the table below:

1	2	3	4	5	6	7	8	9	10	11	12
			Calculating whether NRFAI arises			Calculating US$ tax liability		Converting tax liability to NZ$			
#	Date	Event	Payments (US$)	Deductions (US$)	Deduction > payment	Cash NRWT (US$)	NRFAI NRWT (US$)	Exchange rate	Payments (NZ$)	Cash NRWT (NZ$)	NRFAI NRWT (NZ$)
1	2 Apr 17	Arrangement commences	−1,000					0.80	−1,250		
2	31 Mar 18	Balance date		108.03				0.79			
3	1 Apr 18	Coupon date	60			6		0.79	75.95	7.60	
4	20 Jun 18	NRFAI calculation date			N/A – First year			0.76			
5	31 Mar 19	Balance date		113.55				0.56			
6	1 Apr 19	Coupon date	60			6		0.56	107.14	10.71	
7	20 Jun 19	NRFAI calculation date			120 ÷ 108.03 = 111.1%			0.64			
8	31 Mar 20	Balance date		119.35				0.71			
9	1 Apr 20	Coupon date	60			6		0.71	84.51	8.45	
10	20 Jun 20	NRFAI calculation date			180 ÷ 221.58 = 81.2% = NRFAI triggered		(108.03 + 113.55 + 119.35) x 10% – 18 = 16.09	0.71			22.66
11	31 Mar 21	Balance date		125.78				0.76			
12	1 Apr 21	Coupon date	60			Not required		0.76	78.95		
13	20 Jun 21	NRFAI calculation date			Not required		12.58	0.81			15.53
14	31 Mar 22	Balance date		132.91				0.82			
15	1 Apr 22	Maturity	1,360			Not required		0.82	1,658.54		
16	20 Jun 22	NRFAI calculation date			Not required		13.29	0.80			16.61
17	20 Jul 22	Maturity NRFAI calculation					0.04	0.80			0.05
18	31 Mar 23	Balance date		0.36				0.84			
	Total		**600**	**600**		**60**			**755.09**	**81.61**	

Notes:

- These US$ calculations are identical to the NZ$ borrowing in example 2 except the NRWT amount needs to be converted to NZ$ as shown in the four rightmost columns.
- The income tax deduction shown in column 5 is calculated in US$ before being converted into NZ$. This conversion is not shown in the table above.
- Following these rules NRWT of NZ$81.61 is paid. This compares to NRWT under the existing payment basis NRWT rules of NZ$78.54. Whether the NRFAI rules result in higher or lower NZ$ NRWT will depend on how exchange rates move over the term of the arrangement.

Officials agreed in the Officials' report to the Bill that introduced these rules to provide novation examples which are set out below. Some of the facts in these examples appear non-commercial but are provided to illustrate how the NRFAI rules would apply.

Example 6: Novation – borrower pays less than face value

NZ Co borrows $1,000 from its non-resident parent US Co with annual interest payments of $50 and the principal repaid upon maturity in 10 years.

For each of the first three years NZ Co pays $50 interest and withholds $5 of NRWT. As NZ Co's interest deductions and payments match, the deferral calculation is not triggered so NRFAI does not arise.

At the start of year four NZ Co pays NZ Sub Co, a related party, $800 to take over its obligation under the loan. NZ Co is no longer party to the financial arrangement so completes a base price adjustment that shows $200 of income. NZ Sub Co spreads the $200 difference between the amount it received and the principal repayment over the remaining six years of the arrangement.

At the end of year four NZ Sub Co pays $50 interest and withholds NRWT. The deferral calculation at the end of year four is treated as more than 90% under section RF 2C(6). The deferral calculation at the end of year five does not include any portion of the $200 deduction as this amount is expenditure that is not, and will not be, received by US Co so is excluded under section RF 12D(3).

Example 7: Novation – borrower pays more than face value

NZ Co borrows $1,000 from its non-resident parent US Co with annual interest payments of $50 and the principal repaid upon maturity in 10 years.

For each of the first three years NZ Co pays $50 interest and withholds $5 of NRWT. As NZ Co's interest deductions and payments match the deferral calculation is not triggered so NRFAI does not arise.

At the start of year four NZ Co pays NZ Sub Co, a related party, $1,200 to take over its obligation under the loan. NZ Co is no longer party to the financial arrangement so completes a base price adjustment that shows a $200 deduction. NZ Sub Co spreads the $200 difference between the amount they received and the principal repayment over the remaining six years of the arrangement.

At the end of year four NZ Sub Co pays $50 interest and withholds NRWT. The deferral calculation at the end of year four is treated as more than 90% under section RF 2C(6). The deferral calculation at the end of year five and each subsequent year shows cumulative payments exceed cumulative deductions so NRFAI is never triggered and NRWT remains on a payments basis.

Example 8: Assignment

NZ Co borrows $1,000 from its non-resident parent US Co with no annual interest payments and $2,000 repaid upon maturity in 10 years. The YTM spread is:

Year	Cashflow	Deduction	Accrued balance
0	1,000		1,000.00
1	0	71.77	1,071.77
2	0	76.92	1,148.70
3	0	82.45	1,231.14
4	0	88.36	1,319.51
5	0	94.71	1,414.21
6	0	101.50	1,515.72
7	0	108.79	1,624.50
8	0	116.60	1,741.10
9	0	124.96	1,866.07
10	–2,000	133.93	0.00

The deferral calculation at the end of year 1 is treated as more than 90% but at the end of year two is 0% so NRFAI is triggered. NRFAI at year two, including the first year adjustment, is $148.69 so NRWT of $14.87 is paid.

At the start of year three US Sub Co, a related party, pays US Co $1,100 to take over its rights in the loan. At the end of year three NZ Co is still party to the same arrangement and it is still a related party debt so they pay NRWT of $8.25 on the deemed income of $82.45 for the year.

At the end of the arrangement US Co will have derived $100 profit with $15.39 of NRWT withheld while US Sub Co will have derived $900 profit with $84.61 of NRWT withheld. This difference arises as the amount paid by US Sub Co for the assignment is less than the accrued value at the time of the assignment.

Defining when payments are to a related person

New Zealand borrowers that meet the requirements of section RF 12(1)(a) can pay AIL on a payment of interest that is NRPI. When AIL is paid, this NRPI qualifies for a zero-rate of NRWT. The requirements of section RF 12(1)(a) include that the borrower is not associated with the lender, unless the borrower is a member of a New Zealand banking group.

Back-to-back loans and multi-party arrangements

Before the enactment of the new rules the NRWT and AIL rules did not "look through" to the ultimate lender to a New Zealand borrower. Leaving aside the possible application of the general anti-avoidance provision, this allowed a New Zealand borrower to interpose one or more third parties into what would otherwise be a loan from an associated person. An example of this type of arrangement is a back-to-back loan.

Arrangements have also been entered into that are not back-to-back loans in the conventional sense but which also involve indirect funding by a non-resident lender to a resident associated borrower without the imposition of NRWT, while maintaining an income tax deduction calculated under the financial arrangement rules.

Amendments now define these back-to-back loans and multi-party arrangements as "indirect associated funding" if they are entered into with the purpose or effect that the borrower incurs financial arrangement expenditure and the associate does not derive non-resident passive income from the borrower. Interest payments on indirect associated funding are ineligible for AIL and the New Zealand-resident (or New Zealand branch of a non-resident) borrower will have to consider whether NRFAI arises if interest payments on indirect associated funding have an inappropriate amount of deferral compared with income tax deductions.

Indirect associated funding arises when a non-resident associate of a New Zealand borrower provides funding, directly or indirectly, to a third party so it can be provided to the New Zealand borrower or to reimburse the third party for funds provided to the New Zealand borrower. This also applies to arrangements where part of the funding is provided by an associated non-resident and part is provided by the third party. This is achieved by treating any amount lent by or repaid to the associate as being lent directly to the New Zealand borrower rather than the third party. Any interest payments made by the New Zealand borrower to the third party are treated as being made by the New Zealand borrower to the third party as agent for the associate, to the extent they are attributable to money lent by the associate.

The amendments capture all arrangements involving a New Zealand borrower, third party and an associated non-resident if there is some linkage between the two amounts of funding provided, but not arrangements where there is no linkage, other than the existence of a common third party.

If a borrower does not withhold NRWT on an indirect funding arrangement the direct lender will be required to do so (even if they are themselves a New Zealand resident). This is consistent with the existing treatment of NRWT not being withheld by a payer, aside from the following points:

- The direct lender will not have an obligation to deduct NRWT from the payment received if they have taken actions to confirm this is not a back-to-back loan but have incorrect information. For example, if the borrower incorrectly represents that this is not a back-to-back loan.
- If the arrangement has insufficient interest payments that result in the NRFAI deferral calculation for the borrower being less than 90%, the borrower is required to pay NRWT on the NRFAI. The direct lender cannot be expected to know that this arrangement is NRFAI or the amount of NRFAI calculated so will continue to have the same obligations as above on any interest payments received. Any NRWT withheld by the direct lender on a payments basis will be available to the borrower and/or indirect lender to meet any NRWT liability arising on an NRFAI basis.
- In the event that the above NRWT was not withheld/paid by the relevant parties Inland Revenue would commence collection activity consistent with other debts. Inland Revenue would generally seek to collect this tax from the borrower or the indirect lender in the first instance before seeking to collect from the direct lender and would not seek to recover this tax from the direct lender when they did not originally have an obligation to withhold under the principles above.

Example 9: Commercial arrangement

Foreign Parent has $1,000,000 on deposit with Australian Bank while its subsidiary, NZ Sub, has a $500,000 loan from Australian Bank NZ Branch. Both the deposit and loan are on independent arm's length terms. Withdrawal of the deposit will have no effect on the loan, and the deposit is not security for the loan's repayment. In this case, Foreign Parent is not considered to have provided this deposit so that Australian Bank could lend it to NZ Sub. Therefore, this is not indirect associated funding.

Example 10: Back-to-back loan

NZ Co has a $1,000,000 loan from NZ Bank on which it pays 5% interest. NZ Co's parent, Aus Hold Co has a $700,000 deposit with Aus Bank, the Australian parent of NZ Bank on which it receives 4.9% interest. Bank lending documents show NZ Co pays 5%, instead of 6% charged to other borrowers, due to Aus Hold Co's deposit, and withdrawal of the deposit triggers a right for the Bank to demand repayment of, or to increase the interest rate on, the loan. The new provisions impose NRWT as follows. This analysis would also apply if NZ Bank were instead a branch of Aus Bank.

This arrangement is treated as an indirect funding arrangement with a $700,000 loan from Aus Hold Co (the indirect lender) to NZ Co (the borrower) and a $300,000 loan from NZ Bank (the direct lender) to NZ Co. NZ Co makes $50,000 annual interest payments (the first interest payment) to NZ Bank and Aus Bank makes $34,300 annual interest payments (the second interest payment) to Aus Hold Co. The first interest payment is treated as a $34,300 interest payment from NZ Co to NZ Bank as agent for Aus Hold Co on which the borrower must withhold NRWT and a $15,700 interest payment from NZ Co to NZ Bank which is treated in the standard manner (NZ Bank has an RWT exemption certificate so no RWT is withheld; however, this is assessable income to NZ Bank). The second interest payment from Aus Bank to Aus Hold Co is treated as a payment of money held as an agent so no NRWT or AIL is required.

If NZ Co did not withhold NRWT NZ Bank would be required to pay NRWT on $34,300 of the $50,000 interest payment it received from NZ Co.

NEW LEGISLATION

Example 11: NRFAI and obligations on the direct lender

NZ Co has a 31 March balance date and borrows NZ$1,000 from a third party finance company (NZ Finance Co) on 2 April 2017. This example uses the same figures from example 2. NZ Co will pay $60 of interest on 1 April each year and $1,300 upon maturity on 1 April 2022. Deductions are calculated on a YTM basis with a 364/365ths apportionment between years. On 2 April 2017 NZ Finance Co also borrows $1,000 from NZ Co's non-resident parent with interest of $55 on 1 April each year and $1,300 upon maturity on 1 April 2022. NZ Finance Co is a NZ resident with an RWT exemption certificate.

Assuming these two loans are back-to-back loans, this will be an indirect associated funding arrangement so NZ Co is required to withhold $5.50 of NRWT (assuming 10% is the appropriate withholding tax rate for a payment by NZ Co to its parent) on each $60 interest payment to NZ Finance Co. The NRWT is $5.50 as only $55 of the $60 interest payment is treated as received on behalf of NZ Co's non-resident parent. The terms of the loan between NZ Co and NZ Finance Co require NZ Co to gross the interest payments up so that NZ Finance Co continues to receive $60. On 20 June 2020 NZ Co advises NZ Finance Co that this arrangement has triggered the NRFAI rules and that NRWT will no longer be withheld on the remaining interest payments. NZ Co will be required to pay NRWT to Inland Revenue on the NRFAI arising and neither NZ Co or NZ Finance Co will pay NRWT on the interest payments to NZ Finance Co.

Example 12: NRFAI and obligations on the direct lender

This example is the same as example 11 above, except NZ Co does not comply with its tax obligations.

Upon receiving the $60 interest payment with no NRWT withheld, NZ Finance Co will be required to pay $5.50 of NRWT to Inland Revenue. It is expected the loan agreement would allow NZ Finance Co to recover this amount from NZ Co. On 21 June 2020 NZ Co advises NZ Finance Co that the arrangement has triggered NRFAI so NZ Finance Co stops paying NRWT on interest payments after that date. NZ Co would continue to have a liability for NRWT on the interest payments and NRFAI once the deferral calculation was triggered on 20 June 2020 however, the total amount payable would be reduced by any NRWT paid by NZ Finance Co.

To the extent insufficient NRWT was paid, Inland Revenue would commence collection actions. The attempts to collect this NRWT would likely be from NZ Co and NZ Co's non-resident parent in the first instance. Inland Revenue could also attempt to collect NRWT from NZ Finance Co if this was unsuccessful; however, the maximum amount that could be collected from NZ Finance Co would be capped at NRWT on a payments basis for interest payments before they received the NRFAI notification (that is, $5.50 in each of the April 2018 to April 2020 periods).

Example 13: Commercial cash pooling arrangement

Multinational Group has subsidiaries in a number of countries including New Zealand. Each of these subsidiaries has a notional cash pooling account with Worldwide Bank Ltd which it uses for managing its working capital requirements. The New Zealand subsidiary's balance in the cash pooling account can be positive or negative within limits agreed with Worldwide Bank. During the month of June 2018 the New Zealand subsidiary's average balance is -$50,000 while the parent company's average balance is +$750,000. Worldwide Bank does not charge the New Zealand subsidiary interest for June 2018. The parent company has not put money into the cash pool in order for money to be withdrawn by the New Zealand subsidiary so this is not indirect associated funding and the new rules do not apply. This conclusion is not affected if there is a compensatory payment by the New Zealand subsidiary to the parent.

Example 14: Back-to-back loan through a cash pooling arrangement

US Parent has a $10,000,000 loan to NZ Subsidiary on which the interest payments are subject to NRWT. NZ Subsidiary repays this loan by withdrawing from an account with US Bank. This account is part of a cash pooling arrangement with other members of US Parent's group. US Parent uses the $10,000,000 repaid by NZ Subsidiary to make a deposit with US Bank in an account that is also part of the cash pooling arrangement. Because these amounts offset each other, US Parent does not receive any interest from US Bank but neither does NZ Subsidiary pay interest to US Bank. NZ Subsidiary pays $100,000 per month to US Parent as part of a transfer pricing agreement which is a deductible funding cost to NZ Subsidiary. Section RF 12J treats this arrangement as a loan from US Parent to NZ Subsidiary. This means that the $100,000 per month payment is New Zealand-sourced income for US Parent, from which NRWT must be withheld.

Example 15: Sale of part of a loan to borrower's associate

NZ Co borrows $1,000 from NZ Bank with $100 annual interest payments and the $1,000 repaid in five years. As part of the same arrangement, NZ Bank sells the principal repayment to Aus Parent Co, the ultimate owner of NZ Co for $600. For tax purposes this is treated as two separate financial arrangements, a five-year $400 amortising loan from NZ Bank to NZ Co and a five-year $600 bullet loan from Aus Parent Co to NZ Co as follows:

From	To	Arrangement commences	Year 1	Year 2	Year 3	Year 4	Year 5	Total interest
NZ Bank	NZ Co	–400	100	100	100	100	100	100
Aus Parent Co	NZ Co	–600					1,000	400

There is no equivalent amount paid by NZ Bank to Aus Parent Co so the $100 interest payments by NZ Co to NZ Bank are treated as payments of principal and interest between two New Zealand residents under the financial arrangements rules. The $1,000 final payment, whether paid directly to Aus Parent Co or paid to NZ Bank as agent for Aus Parent Co is treated as a $600 principal repayment and a $400 interest payment from NZ Co to Aus Parent Co, therefore NZ Co must withhold NRWT. However, as NZ Co is claiming financial arrangement deductions for funding provided by an associated non-resident, this arrangement will trigger NRFAI on which NRWT will be required to be paid by NZ Co over the term of the arrangement.

Acting together

Before the amendments were made, the non-association tests for accessing the AIL rules relied on the associated persons definition in subpart YB. One of the tests in the associated person rules states that two companies are associated if a group of persons exists whose total voting interests in each company are 50 percent or more.

This means that if two or more companies each had ownership interests of less than 50 percent in a New Zealand borrower, these companies were not associated with that borrower unless they are themselves associated.

Transactions were identified where two or more non-associated persons (investors), each with less than 50 percent ownership interests in a New Zealand borrower, together provided debt funding to that borrower under an arrangement. Even though these investors may have been genuinely not associated (for example, three pension funds for quite different groups of employees) they could make decisions about the borrower collectively, and in economic substance, operate in a similar manner as if they were a single owner.

By operating in this manner, the investors could make decisions in a similar manner to a single owner such as inserting debt (subject to thin capitalisation requirements) in proportion to their ownership interests and thereby received a return on their total (equity + debt) investment with a large proportion of this being deductible in New Zealand.

This problem was not unique to the NRWT/AIL rules. Until recently, the same structure meant the thin capitalisation rules did not restrict the New Zealand borrower's interest deductions. In March 2017 the Government also announced proposals to address this issue in relation to transfer pricing.

To prevent this, "related party debt" now includes funding provided by a member of a non-resident owning body. This means:

- interest payments on this funding are ineligible for AIL; and
- when interest payments are inappropriately deferred compared with deductions, the arrangement may generate NRFAI.

A non-resident owning body was an existing concept within the thin capitalisation rules; this definition has now been moved to section YA 1. The thin capitalisation "acting together" rules were explained in greater detail in *Tax Information Bulletin* Volume 26, No 7, August 2014. In short, a non-resident owning body is a group of non-residents or entities (such as trusts settled by non-residents), that have one or more characteristics indicating they are acting together to debt-fund a New Zealand company. These characteristics include:

- having proportionate levels of debt and equity among the group;
- an agreement that sets out how the company should be funded with member-linked funding if the company is not widely held (a term defined in section YA 1); and
- member-linked debt in the company in a way recommended by a person (such as a private equity manager), or implemented by a person on behalf of the members.

Proportionality is a characteristic of acting together as it generally requires a degree of coordination to achieve. More generally, proportionality is also a situation where shareholders are able to substitute debt for equity. This is because, where there is proportionality, the level of debt in a company does not change shareholders' exposure to the risk of holding equity in the company or shareholders' overall return. Due to the ability to structure an arrangement to achieve this outcome without explicit proportionate debt, the test is structured to cover transactions that may not have proportionate debt but can still be considered the result of acting together.

Prepayments of interest

A transitional prepayment rule prevents a company effectively continuing the previous non-imposition of NRWT beyond application of the new rules by prepaying interest on a financial arrangement before the new rules took effect. This situation may arise when a borrower is required to withhold NRWT on interest on an arrangement that became a related-party debt when the new rules come into force but was not previously paying non-resident passive income (for example, because of the onshore branch exemption) or was paying AIL on interest to an unassociated party (for example, as part of an arrangement that is now treated as a loan from persons who are associated with the borrower because they are acting together). The prepayment rule compares the amount of interest paid with any financial arrangement deductions taken to the date the new rules apply. Any excess interest paid is treated as being paid on the first day the new rules apply and will therefore be liable for NRWT. Any AIL previously withheld on these interest payments can be refunded or transferred against an existing tax liability.

This rule is not intended to capture foreign exchange movements on arrangements denominated in foreign currencies. When an arrangement is denominated in a foreign currency both the interest payments and total expenditure should be calculated in that foreign currency and then any excess converted to New Zealand dollars using the existing rules in subpart YF of the Income Tax Act 2007.

Example 16: Prepayment rule

NZ Co is owned 25 percent each by four non-resident private equity funds. NZ Co has been making interest payments to each fund of $100,000 per year and paying $2,000 of AIL on each interest payment. As NZ Co knows its owners will be treated as acting together when the new rules apply to their interest payments after 1 April 2017 they agree that on 1 January 2017 NZ Co will make a one-off interest payment to each fund of $800,000 with no further interest payments until after 1 April 2027. NZ Co pays $16,000 of AIL on each of these payments in its January 2017 AIL return. On 1 April 2017 it is calculated that interest payments exceed deductions by $700,000 for each fund; therefore, NZ Co is treated as paying $700,000 to each fund on 1 April 2017 and only $100,000 to each fund on 1 January 2017. $70,000 of NRWT is required to be paid on behalf of each fund. NZ Co can apply to the Commissioner to have $14,000 of AIL refunded for the interest payment to each fund that is no longer treated as being paid on 1 January 2017.

Interest payments by a member of a registered banking group

For a New Zealand bank that is part of a wider worldwide banking operation, there are commercial reasons why the New Zealand bank may borrow from its parent or another associated entity. This can include the better credit rating held by the larger parent, economies of scale of a single funding operation and/or better name recognition of the parent, which allows funding to be raised more cheaply.

It can reasonably be considered that funding on-lent to a New Zealand bank by its parent is ultimately largely borrowed from unrelated parties and not generally provided by the parent bank's shareholders as a substitute for equity.

As the offshore and onshore branch exemptions have been restricted, New Zealand banks can no longer rely on these structures to remove their NRWT liability.

In the absence of further changes, New Zealand banks would have had a tax incentive to raise all funding from third parties so that AIL could be paid instead of NRWT even when, in the absence of tax, it would be economically efficient to borrow through an associated party.

Changes to section RF 12(1)(a)(ii) allow a member of a banking group to pay AIL on interest payments to an associated non-resident. These changes have not been extended to non-banks, including other businesses operating in the financial sector. This is because, unlike other industries, banks already have a clear definition which removes boundary issues and provides confidence that related-party funding is not an economic substitute for equity investment. This is consistent with other legislation where New Zealand-registered banks are subject to more rigorous thin capitalisation requirements and greater regulatory oversight by the Reserve Bank of New Zealand, than other financial sector taxpayers.

Branch lending changes

A number of amendments have been made to the NRWT rules and the source rules that ensure that interest payments from a New Zealand resident (or a New Zealand branch of a non-resident) to a non-resident are subject to NRWT or AIL irrespective of whether that funding is channelled through a branch or an entity that has a branch. This ensures that funding transactions that are economically equivalent have a consistent tax treatment.

Offshore branch exemption

Changes to the source rules apply NRWT or AIL to an interest payment from the offshore branch of a New Zealand resident to a non-resident to the extent that the offshore branch lends money to New Zealand residents.

Onshore branch exemption

Changes to the NRWT rules apply NRWT or AIL to an interest payment from a New Zealand resident (or New Zealand branch of a non-resident) to a non-resident if that non-resident has a New Zealand branch, unless the interest is derived by the New Zealand branch. These changes do not apply to a New Zealand resident (or New Zealand branch of a non-resident) that pays interest to a non-resident that they are not associated with and that has a New Zealand branch that holds a banking licence.

Onshore notional loans

New subpart FG and changes to the NRWT rules apply NRWT or AIL (to the extent it was not already) to a notional interest payment from a New Zealand branch of a bank to its head office. This interest payment will be equal to the amount already included in the branch's financial statements and claimed as a deduction against New Zealand income of the branch.

Application date

For existing arrangements, the branch amendments apply to interest payments on or after the date shown in the table below. For all other arrangements, the branch amendments apply to interest payments on or after the day the Bill was enacted, being 30 March 2017.

Scenario	Borrower	Lender	Application date for existing arrangements	Intended regime
Onshore branches				
Related party	NZ Corporate	Foreign associate with NZ Branch	Royal assent	NRWT
Intra-bank Group	NZ Bank Sub	Foreign parent with NZ Branch	Income years five years after Royal assent	NRWT or AIL
Intra-bank Entity	NZ Bank Branch	Foreign head office	Income years two years after Royal assent	NRWT or AIL
Corporate	NZ Corporate including NZ Bank	Third Party with NZ Branch	Income years five years after Royal assent	NRWT or AIL
Third party bank	NZ borrower	Foreign bank with NZ Branch	No change	Net income tax
Offshore branches				
Wholesale funding	NZ Bank Sub branch	Third parties or Foreign parent	Income years five years after Royal assent	NRWT or AIL

The ability for a member of a banking group to pay AIL on an interest payment to an associated party applies from the date of enactment, being 30 March 2017.

Further detail is provided on application dates under *Key features* below.

Key features

Offshore branch exemption

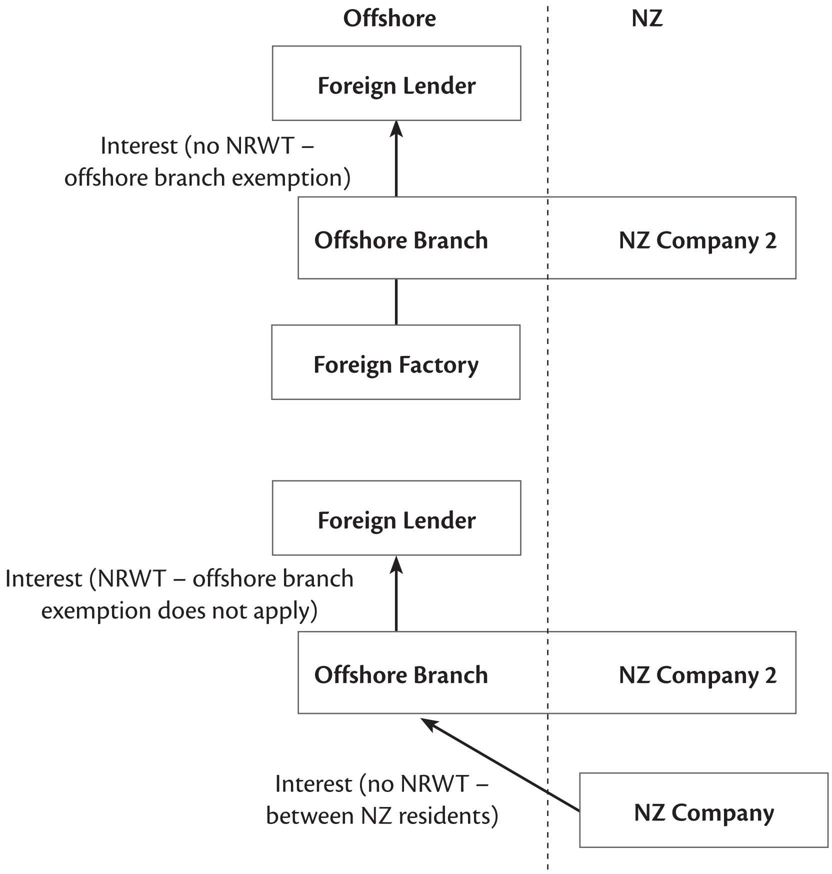
NRPI includes only income that has a New Zealand source. One of the exclusions from having a New Zealand source is the offshore branch exemption.

This exemption is intended to apply to a New Zealand resident operating an active business through a branch in another country. If that offshore branch borrows money to fund its offshore operations, the interest on this funding should not be subject to NRWT. This treatment ensures that the offshore branch of a New Zealand company does not have to pay NRWT when a foreign incorporated subsidiary borrowing for an equivalent business would not have to.

However, this exemption previously applied when a New Zealand company set up an offshore branch that borrowed money for the purpose of providing funding to New Zealand borrowers, who may have been associated or unassociated with the New Zealand company.

The amendments result in an interest payment by an offshore branch of a New Zealand resident to a non-resident having a New Zealand source to the extent that the branch lends to New Zealand residents.

Application of offshore branch exemption



It is possible for an offshore branch of a New Zealand resident to have a business that includes lending to New Zealand residents and other business conducted outside New Zealand. In this instance, any interest payments by the branch are apportioned based on the proportion of branch assets that are financial arrangements producing New Zealand-sourced income. De minimis provisions in section YD 5(6) and (7) apply when assets deriving New Zealand-sourced income are less than 5% or more than 95% of a branch's assets.

To ensure that interest payments by an offshore branch are appropriately subject to New Zealand tax, section 86IC of the Stamp and Cheque Duties Act 1971 has been inserted to make the payment of AIL mandatory on relevant interest payments unless NRWT is withheld.

Grandparenting of the offshore branch exemption

The changes to the offshore branch exemption apply to interest payments on arrangements entered into before the enactment of the Bill on 30 March 2017 after a grandparenting period of five complete income years post-enactment. This reflects that these offshore branches have entered into commercial arrangements, frequently with unassociated parties, for terms that usually do not exceed five years, and that have been ultimately used to fund New Zealand borrowing, which is also often at fixed interest rates.

All other interest payments by offshore branches apply the new rules from the date of enactment, being 30 March 2017.

Onshore branch exemption

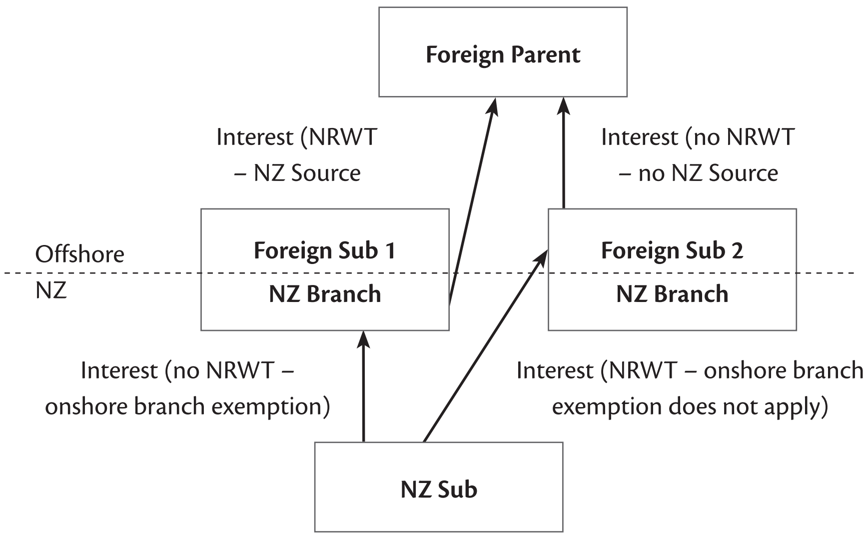
New Zealand-sourced interest income derived by a non-resident was not previously NRPI when the non-resident lender was engaged in business in New Zealand through a fixed establishment in New Zealand. This exemption from NRPI is known as the "onshore branch exemption".

This exemption applied irrespective of whether the lending was made through the New Zealand branch. As with the New Zealand branch income, this non-branch (but New Zealand-sourced) income is subject to New Zealand net income tax. This means it was possible for a non-resident parent to lend money to its New Zealand subsidiary with no tax payable on the interest (other than income tax on a very slim margin). The parent could simply lend the money to the head office of a non-New Zealand group company which had a New Zealand branch. The head office of that company could then lend the money to a New Zealand group company.

The onshore branch exemption has been narrowed so that it only applies to interest payments derived by the New Zealand branch of a non-resident.

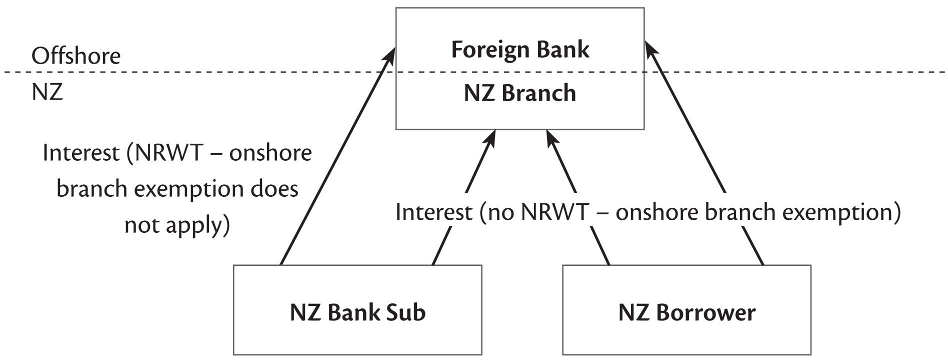
The following diagrams illustrate the new rules.

Application of onshore branch exemption



One exception to this is that the onshore branch exemption continues to apply to loans not made by the onshore branch if the non-resident lender has a New Zealand branch that holds a banking licence and is not associated with the borrower. This is mainly to minimise compliance costs for individual borrowers who were not previously, but would otherwise be, required to withhold NRWT or pay AIL on interest payments to foreign banks for mortgages over foreign properties.

Application of onshore branch exemption to borrowing from foreign banks



Grandparenting of the onshore branch exemption

When a New Zealand resident, other than a registered bank or certain securitisation vehicles, is borrowing from an associated non-resident that has a New Zealand branch, these amendments came into force on the date of enactment, being 30 March 2017.

When the New Zealand resident is borrowing from an unassociated non-resident that has a New Zealand branch, or when the borrower is a bank or certain qualifying securitisation vehicles, these changes will apply after a grandparenting period of five years. This is because these are, directly or indirectly, with unrelated parties and reflect arm's-length transactions that are frequently entered into for longer terms.

This grandparenting applies to interest payments by securitisation vehicles that are a trustee of a trust that, as its core business:

- has no trust property other than financial arrangements and property incidental to financial arrangements; and
- has total debt that is sourced from another securitisation vehicle, a person who is not associated with the trustee, or an authorised deposit-taking institution regulated by the Australian Prudential Regulation Authority; and
- provides funds, directly or indirectly, only to a resident who is not associated with the trustee, unless the association arises because the resident, or another person associated with them, is a settlor of the trust as an incident of the arrangement.

These criteria ensure that the grandparenting only applies to securitisation vehicles that, as their core business, borrow money from third parties or Australian authorised deposit-taking institutions (such as banks) to on-lend to unassociated New Zealand residents.

Onshore notional loans

The amendments equalise the tax treatment between foreign banks that channel offshore funding through their New Zealand subsidiaries and foreign banks that channel offshore funding through their New Zealand branches. In both cases the subsidiary and the branch can claim a deduction for an interest expense on funding provided by their foreign operations (a notional interest expense in the case of the branch). But whereas the subsidiary has always had to pay NRWT (or AIL going forward under other amendments discussed above) on its interest payment, the branch previously paid neither because there is no actual interest flow to the extent that its payment is to head office rather than to a separate company (because it is not possible for one part of an entity to make a legally recognised payment to another – the "payment" is merely a movement of funds).

This was an inconsistent result and had the potential to distort behaviour. Australia has rules which are similar, in substance, to the changes. The Australian rules apply a 5% withholding tax to a notional interest payment by a branch to its head office.

An amount that the head office makes available to the branch, that is recorded in the branch's accounting records, is a notional loan from the head office to the branch. When the branch is allowed a deduction as an interest payment on that notional loan it will be a notional interest payment that can be subject to NRWT or AIL. NRWT or AIL will be calculated on an accrual basis to match that already calculated by the banks for financial reporting and income tax purposes.

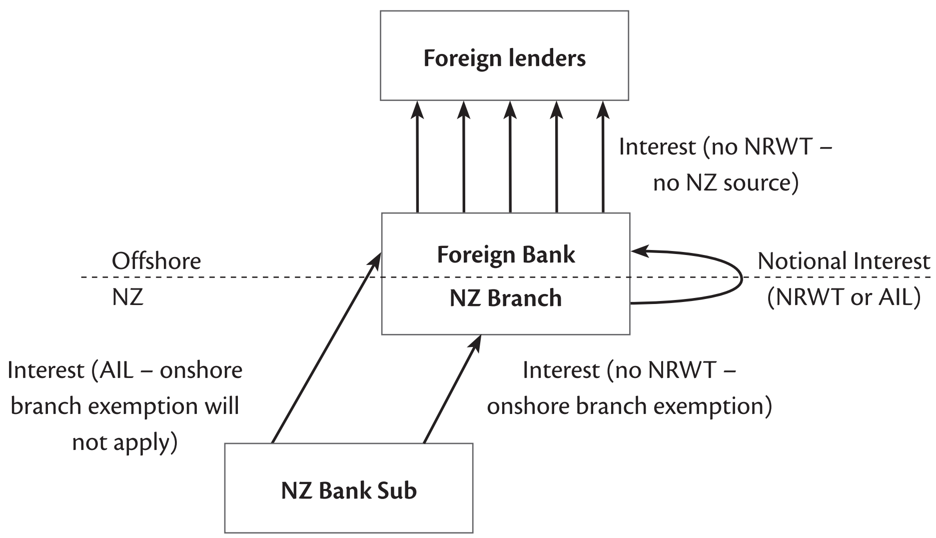
When a foreign-owned bank borrows specifically to fund its New Zealand operations through a New Zealand branch any interest payments have always had a New Zealand source and been subject to NRWT or AIL. Accordingly, these interest payments are removed from the notional loan changes so they are not subject to NRWT or AIL twice.

Like the offshore branch changes discussed above, these notional interest payments will require AIL to be paid if NRWT is not withheld.

Interest on notional loans is deemed to be paid on the last day of the third month following an income year. This period matches the period within which the interest charge must be calculated for non-tax reporting purposes.

If a subsequent transfer pricing adjustment reduces the income tax deduction available for a notional loan new section 86GB(1)(b) will also reduce the AIL liability by the same amount.

New treatment of notional loans



NEW LEGISLATION

Grandparenting of the notional loan changes

A degree of grandparenting is appropriate as these notional loans have been used to provide funding at fixed rates to New Zealand borrowers. However, unlike the offshore branch exemption and onshore branch exemption changes discussed above, funding allocated to the New Zealand branch cannot be identified from a specific loan that may have a fixed maturity date (otherwise it would already be subject to NRWT/AIL). These rules will therefore apply to existing arrangements after a grandparenting period of two years.

Example 17: Notional loans

UK Bank, which has a 31 December balance date, is registered with the Reserve Bank of New Zealand for operations through its New Zealand branch. On 1 January 2017 UK Bank allocates NZ$1 billion of funding to its New Zealand branch. This funding is provided for a term of five years at a fixed interest rate of 5%.

Inland Revenue has reviewed this funding and did not identify any significant mispricing, and has rated the transaction for transfer pricing purposes as a low risk. Accordingly UK Bank's NZ Branch will include $50 million of interest expenditure in its financial statements and income tax returns for the years ended 31 December 2017 to 31 December 2021.

As this transaction was entered into prior to the enactment of the new rules it will qualify for the two year grandparenting. Therefore the notional loan changes will apply to the loan from 1 January 2020. Before 31 December 2020 UK Bank's NZ Branch registers as an approved issuer (if they were not already) and provides a completed IR 397 form to treat the loan as a registered security.

UK Bank's NZ Branch is treated as paying NZ$50 million of interest on a registered security to UK Bank on 31 March 2021 (for the year ended 31 December 2020) and 31 March 2022 (for the year ended 31 December 2021). It includes $50 million of interest payments and $1 million of approved issuer levy in its AIL returns for the 31 March 2021 and 31 March 2022 periods.

GST CURRENT ISSUES

GST and capital raising costs

Sections 20(3)(hd) and 20H of the Goods and Services Tax Act 1985

The Goods and Services Tax Act 1985 has been amended to allow GST-registered businesses to recover GST on their costs of raising capital to fund a taxable activity.

Background

Supplies of financial services in New Zealand are generally exempt from GST, so GST is not charged on the value of the supply, and the supplier cannot claim input tax deductions in relation to that supply.

The policy rationale for this treatment is that the nature of financial services makes them difficult to integrate with the GST system, where liability for tax arises on a transaction-by-transaction basis throughout the production and distribution chain. This is because it is difficult to measure the amount paid for a financial service, as the financial service provider may be compensated through a margin or spread rather than an explicit fee. Due to the difficulty in taxing the value of services supplied by a financial service provider, the next best option is to effectively tax the supply by denying input tax deductions.

Under the previous rules, the exempt treatment of financial services could, however, pose a problem when businesses that principally made taxable supplies of goods and services incurred costs to raise capital, such as through the issue of bonds or shares. Examples include NZX listing fees, legal fees and costs associated with preparing a product disclosure statement. The GST incurred in relation to these costs was unrecoverable because the provision of equity and debt securities is an exempt supply of financial services.

The new rules ensure that businesses which principally make taxable supplies can recover the GST incurred on goods and services used to raise capital for their taxable activities. The new rules do not apply when a business principally makes supplies of financial services, or to the extent that they have made an election to zero-rate business-to-business supplies of financial services and a deduction is already available as a result of the business-to-business zero-rating rules.

Key features

The new rules apply to GST-registered persons that principally make taxable supplies, and that make exempt supplies of certain financial services in the course of a capital-raising exercise intended to fund their taxable activity.

Instead of zero-rating supplies of financial services as first proposed in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill 2016 upon introduction, the initial zero-rating proposal has been replaced with a new deduction rule. New sections 20(3)(hd) and 20H allow such businesses to claim back the GST on these capital raising costs when the existing rules under section 20(3) do not already allow a deduction.

Registered persons who principally make taxable supplies are also entitled to claim back the GST on their capital-raising costs when the capital-raising attempt is unsuccessful – provided that if the capital raising had been successful, the funds raised would have been used for expenditure in an activity of making taxable supplies.

This means that while supplies of financial services for capital raising are still exempt, a deduction can be claimed for the GST incurred in making these supplies (when the supplies are made with the intention of raising capital for a taxable activity) without a requirement for taxpayers to include any other values in their GST returns in respect of these supplies. This is a compliance cost-saving measure so that businesses that ordinarily make taxable supplies are not required to value these supplies of financial services.

However, it is intended that where a registered person carries on both taxable and exempt activities, or where the funds raised are intended to be used for some combination of making taxable supplies and exempt supplies, the deduction should be apportioned based on the extent to which a taxpayer makes taxable supplies as a proportion of their usual total supplies.

Application date

The new rules came into force on 1 April 2017.

Detailed analysis

Financial services and persons covered

The new rules apply to the following supplies, which are "financial services" under section 3(1):

- the issue or allotment of a debt or equity security;
- the renewal of a debt or equity security;
- the payment of an amount of interest, principal or dividend under a debt or equity security; and
- the provision or variation of a guarantee of the performance of obligations to do one of the above.

The new rules do not apply when the registered person principally makes supplies of financial services, or to the extent that they have made an election to zero-rate business-to-business supplies of financial services, and a deduction is already available as a result of the business-to-business zero-rating rules. Registered persons may only claim a deduction under the new rules for goods and services used to make these supplies of financial services to the extent that a deduction is not already available under the existing rules in section 20(3).

Non-residents who are registered for GST under section 54B are not eligible to claim deductions for capital raising costs under the new rules. However, if a non-resident who is registered under section 54B makes supplies of financial services to other non-residents who are outside New Zealand at the time the services are performed, the non-resident can claim back its New Zealand GST costs of raising capital under existing section 20(3L).

Apportionment of deductions

It is not intended that the ordinary apportionment and adjustment rules apply to the new capital raising rules in sections 20(3)(hd) and 20H because of the difficulty for businesses in tracing their costs of raising capital to a particular activity. This is because money is fungible between activities, thus making it difficult to determine the extent to which capital is being raised to finance the taxpayer's taxable, as opposed to exempt, activities.

Instead, it is intended that the taxpayer should apportion their capital-raising costs according to the extent to which they ordinarily make taxable supplies. In other words, the apportionment should be based on the registered person's usual ratio of taxable supplies as a proportion of their total supplies, excluding the supplies made for raising capital themselves.

Example

A Co. is a property developer, and makes 80 percent taxable supplies and 20 percent exempt supplies. It issues a bond to raise capital in order to finance the purchase of land. In issuing the bond, it spends $11,500 in legal fees, including GST of $1,500. A Co. claims a deduction of $1,200 (80 percent of $1,500) based on A Co.'s usual ratio of taxable to exempt supplies (excluding the bond issue itself).

Because the bond issue is a supply of an exempt financial service and not a zero-rated supply, A Co. is not required to include the amount of consideration for the supply in Boxes 5 and 6 of its GST return.

Agreed methods of apportionment and adjustment

Sections 20(3E)(a), (3EB), (3F) and 21(4B) of the Goods and Services Tax Act 1985

Amendments to the Goods and Services Tax Act 1985 allow large, partially exempt businesses to agree an alternative method of apportioning and making adjustments to input tax deductions with the Commissioner of Inland Revenue. The new provisions are intended to address high compliance costs faced by large businesses that supply a combination of taxable and exempt supplies by providing them with a simpler alternative to the ordinary apportionment and adjustment rules.

Background

Exempt supplies are effectively taxed under the GST legislation by denying deductions for the GST incurred on the supplier's purchases of goods and services ("input tax") used to make the supply. In some cases, a business may incur GST on goods and services that it uses to make both taxable supplies and exempt supplies. The business will generally need to apportion the GST incurred. The rules dealing with apportionment of GST and, if applicable, subsequent adjustment of apportioned deductions, allow GST to be deducted to the extent that the goods and services are used for making taxable supplies.

Businesses make an apportionment upon acquisition of goods and services, generally with limited further adjustments. However, when the use of the goods or services differs from that estimated upon acquisition, the business may be required to adjust the claimed deduction. It may then be required to repay an amount of a claimed deduction, or be able to claim a further deduction.

In some cases, businesses may be required to perform a greater number of adjustments to apportioned input tax deductions, and may incur greater difficulty in applying these rules.

For example, retirement village operators may make both taxable and exempt supplies of accommodation in their villages, and the same unit may be used to make both kinds of supplies over its lifespan. In the absence of an alternative method of apportioning and making adjustments to input tax, use of a large number of goods and services acquired by the village may need to be individually tracked and adjustments made. This can result in high compliance costs.

The new rules ease the compliance burden for large, partially exempt businesses by allowing them to agree a fair and reasonable method of apportionment and adjustment with the Commissioner of Inland Revenue.

Key features

The alternative method must reach approximately the same expected outcome as that obtained by applying the ordinary apportionment and adjustment rules.

Use of the method will be subject to agreement with the Commissioner and can be applied for either by a business (including a GST-registered group) if the business has a turnover exceeding $24 million, or by an industry association.

The option to allow industry bodies to negotiate industry-wide apportionment methods on behalf of their members provides a cost-effective, compliance cost-saving option for members. Members still have the option of applying the existing apportionment and adjustment rules instead of the industry-agreed methods if that is preferred.

Application date

The new rules came into force on the date of enactment, being 30 March 2017.

Detailed analysis

New sections 20(3EB) and 21(4B) allow a registered person to use an alternative method of apportionment and adjustment. The method is required to be fair and reasonable, having regard to the outcomes that would be reached if the apportionment and adjustment rules were applied. In some cases there may be a change in the timing of a deduction, and it is expected that the agreement would take account of the time value-of-money (for example, by reducing the deduction slightly to reflect this advantage).

While the legislation does not provide a list of factors that an agreed method must take into account, it is expected that agreements should contain information such as the following:

- all relevant business activities of the applicant;
- the methodology proposed (for example, calculation based on turnover, floor space, time spent, number of transactions or cost allocations);
- an explanation of why the proposed methodology is fair and reasonable, and how it reflects the outcomes that could be reached under the apportionment rules;
- categories of costs that can be directly attributed to either taxable or non-taxable supplies, and categories of costs that relate to both taxable and non-taxable supplies;
- the methodology proposed for significant one-off acquisitions such as land;
- the method by which disposals of assets will be dealt with (for example, what input tax adjustments will be made);
- any adjustments that will be made in relation to goods and services that have already been acquired, including those that are subject to the current apportionment rules, transitional rules or old apportionment rules;
- details of any proposed variations to the minimum number of adjustment periods for which adjustments will be made; and
- details of any proposed variations to the period in which adjustments will be returned.

Scope of eligibility

The amendments allow two groups to agree an alternative method of apportionment and adjustment with the Commissioner of Inland Revenue:

- registered persons with a turnover exceeding or expected to exceed $24 million in a 12-month period; and
- industry associations.

Registered persons exceeding the turnover threshold are able to agree a method with the Commissioner which applies to their own activities. The turnover threshold can be applied on a group basis if taxpayers are group-registered for GST.

Industry associations can agree methods on behalf of industry members. As part of the agreement, the Commissioner and the association need to agree on the persons or class of persons that are eligible to apply the method (with any necessary adaptations).

Incidental changes

Incidental amendments to section 20(3E)(a) and (3F) have been made to update cross-references to other sections.

Secondhand goods, and gold, silver and platinum

Section 2(1) of the Goods and Services Tax Act 1985

The definition of "secondhand goods" in the Goods and Services Tax Act 1985 has been amended to allow deductions to be claimed for goods composed of gold, silver or platinum, and which are of a kind manufactured for sale to the public, under the same rules applying to secondhand goods.

Background

Registered persons who acquire secondhand goods from non-registered persons may claim a GST deduction even though GST is not charged on the supply. The rules allowing deductions for secondhand goods recognise that GST will have been incurred by the non-registered supplier, and that this GST is embedded in the cost of the secondhand goods to the registered person.

Exceptions were included under the former rules for secondhand goods composed of gold, silver and platinum. Goods composed of these substances (collectively referred to as "gold") were excluded from these rules in two circumstances:

- when the good is "fine metal" (gold, silver and platinum are "fine metal" when they are of a fineness of 99.5%, 99.9% and 99.0%, respectively); and
- to the extent that the good is composed of a substance which, if it were of the required fineness, would be "fine metal".

The new definition of "secondhand goods" in the Goods and Services Tax Act 1985 has no impact on the first exception above. This first exception recognises the inappropriateness of allowing secondhand goods credits for goods which are fine metal, since the supply of these goods would be either exempt from GST, or instead zero-rated in the case of the first supply of newly refined fine metal.

The second exception was due to an historic concern that the treatment of fine metal could give rise to a fiscal risk from the conversion of fine gold into a lower purity, non-fine form by a non-registered person, which would then be supplied to a registered person. Allowing secondhand goods deductions for goods purchased in a non-fine, gold alloy form would potentially provide GST input credits for untaxed gold.

While the second exception to the secondhand goods rules for gold would likely have mitigated this fiscal risk, the exception also adversely impacted persons dealing in other goods which pose a lower risk of this kind of fraud, such as finished consumer goods like jewellery. This may have led to the consumption of these goods being taxed more than once, giving rise to concerns about tax cascades.

Key features

The new rules expand the definition of "secondhand goods" in section 2(1) by narrowing the exception which applied to goods composed of gold. This allows deductions to be claimed for secondhand goods composed of alloy gold, provided that the goods have undergone a manufacturing process (so that they are in the form of finished goods that a consumer would buy).

This allows deductions to be claimed for the gold alloy content of a variety of goods, such as jewellery. Deductions cannot be claimed for unmanufactured goods acquired from non-registered persons, to the extent that these goods are composed of gold. This is because the kind of fraud envisaged by the exclusion could remain open if deductions were allowed for these unfinished goods.

Transitional provision

The amendment also includes a transitional provision so that deductions can be claimed for goods acquired in the four years preceding 30 March 2017 (the date of enactment), or for goods acquired in an earlier period where a claimed deduction was reassessed by the Commissioner of Inland Revenue within the four years preceding 30 March 2017. This recognises that industry practice has been mixed, and ensures that businesses that claimed deductions prior to the application of the new legislation are not subject to reassessments, but also that businesses which complied with the earlier legislation are not disadvantaged.

Example

B Co. is a gold refiner. B Co. purchases various secondhand gold jewellery items from consumers as inputs for making B Co.'s zero-rated supplies of newly refined fine gold to gold dealers. Because the goods that B Co. acquires from consumers are of a kind manufactured for sale to the public (in other words, the goods have undergone a manufacturing process, and are in a finished form that a consumer would buy), B Co. can claim a secondhand goods deduction for the gold jewellery.

However, if B Co. instead acquired alloy gold from a non-registered person which was not of a kind manufactured for sale to the public (that is, an item of melted down gold which had not undergone a further manufacturing process, but which was still in an unprocessed state) then B Co. would not be able to claim a deduction for the alloy gold component of the good under the amended secondhand goods definition.

Application date

The new rules came into force on the date of enactment, being 30 March 2017.

Services connected with land

Sections 11A(1)(e) and (k) of the Goods and Services Tax Act 1985

An amendment to the Goods and Services Tax Act 1985 applies GST to a wider range of services, particularly professional services, supplied to non-residents who are outside of New Zealand and which closely relate to land in New Zealand. The new rules also ensure that, when these services are provided in relation to land outside New Zealand (whether to residents or to non-residents), they are not charged with GST.

Background

A key concept underpinning New Zealand's GST framework is the destination principle. Under this principle, supplies of goods and services are taxed in the jurisdiction where the goods and services are consumed. This means that exported goods and services supplied to non-residents who are outside New Zealand will generally be zero-rated, based on the presumption that the goods or services will be consumed overseas.

An exception applies for supplies of services which are so closely connected with land that the jurisdiction in which the land is located is considered the most appropriate place of taxation. Hence, services supplied to non-residents who are outside New Zealand are not zero-rated when the services are supplied directly in connection with land situated in New Zealand. Similarly, services that are supplied directly in connection with land situated outside New Zealand are zero-rated (GST levied at 0%).

These rules for taxing land-related services are consistent with the "place of taxation" rules set out in the OECD's *International VAT/GST Guidelines*. The *Guidelines* suggest that taxing rights over certain services connected with land may be allocated to the jurisdiction where the property is located. In particular, the *Guidelines* suggest this treatment may be appropriate for:

- supplies of immovable property itself or the right to use that property;
- supplies of services physically provided to the immovable property itself; and
- other supplies of services with a very close, clear and obvious link or association with the property.[7]

In the case of a number of services in the third category above, Inland Revenue's interpretation (based on the leading cases *Malololailai Interval Holidays New Zealand Ltd v Commissioner of Inland Revenue* (1997) 18 NZTC 13,137 and *Wilson & Horton Ltd v Commissioner of Inland Revenue* (1994) 16 NZTC 11,080) is not consistent with the *Guidelines*. The "directly in connection" test has been interpreted more narrowly than may have been intended by the original policy: therefore a number of services in the third category are unlikely to satisfy the "directly in connection" test.

This resulted in the potential exclusion of professional services such as architectural, real estate or legal services, which are supplied with the intention of facilitating a change in the legal or physical nature of the land, but do not involve a more physical intervention with the land.

In addition, the New Zealand interpretation of the "directly in connection" test was not aligned with the international approach. Misalignment with the approaches of other countries gives rise to a risk of some services being taxed in more than one jurisdiction, or not being taxed in any jurisdiction at all.

The new rules are designed to ensure that New Zealand's legislation reflects the policy intent and international practice.

Key features

From 1 April 2017, GST applies to an expanded range of services, particularly professional services, which are closely related to land in New Zealand. These services will be zero-rated where they relate to land outside New Zealand.

The new rules supplement the existing "directly in connection" with land test by adding an additional test. Under the expanded rules, GST applies to services supplied in connection with land in New Zealand and which are "intended to enable or assist a change in the physical condition, or ownership or other legal status" of the land.

Services connected with land outside New Zealand and which are intended to enable or assist a change in the physical nature, or ownership or other legal status of the land outside New Zealand are zero-rated.

The requirement that the services be supplied in connection with land (as described in the amendments) is intended to differentiate between services that have a close connection with specific land (such as those relating to the purchase of a specific property) that can therefore be regarded as consumed in New Zealand, and services that relate to land more generally (such as seeking general advice on land law or the housing market in New Zealand).

Under the new test, the relevant services must be intended to enable or assist a change in the physical condition, ownership or other legal status of the land or improvement. The reference to "services intended to enable or assist a change in the physical condition" ensures that services that form an integral part of a process of physically changing the land, but do not do so themselves (such as engineering and architectural services), are captured.

By adding to services connected with land services that are "intended to enable or assist a change in the… ownership or other legal status of the land", a variety of professional services (such as legal or real estate agents' services as part of a land transaction) are expected to be included because the intended outcome is to change the legal nature of the land, even though the services do not involve any physical change or connection to the land.

This ensures that the GST treatment stems from the location of the land as a proxy for where the services are effectively consumed (consistent with the destination principle and with international practice), rather than the location or residence status of the recipient of the services. This also better aligns the treatment of services provided to non-resident purchasers of New Zealand land so that these services are subject to GST at 15%, consistent with similar services provided to resident purchasers.

[7] Guideline 3.8.

Application date

The new rules came into force on 1 April 2017.

Detailed analysis

The general place of supply rules

The GST Act imposes GST on goods and services supplied in New Zealand. The Act adopts a broad set of rules to determine whether a good or service is considered to be supplied in New Zealand.

If a New Zealand-resident person supplies services, the supply is treated as having been made in New Zealand, and is therefore subject to GST. Where a non-resident person supplies services, the starting point is that the supply is treated as having been made outside New Zealand, and is therefore not subject to New Zealand GST.

However, under section 8(3), services supplied by a non-resident are treated as having been supplied in New Zealand (and are therefore subject to GST) if:

- the services are physically performed in New Zealand by a person who is in New Zealand at the time of performance (section 8(3)(b)); or
- the services are "remote services" supplied to a person resident in New Zealand (section 8(3)(c)).[8]

Rules applying zero-rating to supplies of services to non-residents

The place of supply rules in section 8 are followed by a range of exclusions that determine whether the supply is zero-rated or exempt rather than taxed at the normal 15% rate.

Subject to a few exceptions (for example, services directly connected with land or with moveable personal property), section 11A(1)(k) applies to zero-rate supplies of services made in New Zealand to non-residents who are outside New Zealand at the time the services are performed. New section 11A(1)(k)(i) excludes from zero-rating services that are supplied in connection with land in New Zealand (or with an improvement to New Zealand land) and which "are intended to enable or assist a change in the physical condition, ownership or other legal status" of the land, in addition to services that are supplied directly in connection with land situated in New Zealand.

Hence, under the new test, services relating to land located in New Zealand are zero-rated but are subject to GST at the standard rate of 15% when:

- their supply is directly in connection with land or an improvement to the land (the existing test); or
- their supply is in connection with land in New Zealand or an improvement to the land, and is intended to enable or assist a change in the physical condition, ownership or other legal status of the land or improvement.

Example 1

Serj is a non-resident who owns a parcel of land in Andersons Bay, Dunedin. He initially intended to have a house constructed on it as his own personal home for when the time came for him to move to New Zealand. However, his immigration plans have fallen through, so he now intends to sell the land. He arranges via email for the New Zealand land to be advertised for sale in a New Zealand newspaper. The supply of advertising services does not qualify for zero-rating under section 11A(1)(k), as the exclusion in paragraph (i) applies: the advertising services are supplied in connection with New Zealand land and are intended to assist a change in the ownership status of the land. The supply is therefore charged with GST at 15%.

[8] Note that there are exceptions for services supplied by non-residents to GST-registered businesses: section 8(4) provides that if a supply (that is not of a remote service) is made to a GST-registered business for the purposes of carrying on their taxable activity, the services are considered to be supplied outside New Zealand, and therefore are not subject to GST, unless the parties agree that GST will apply. Section 8(4D) similarly provides that if remote services are supplied to a GST-registered business for the purposes of carrying on their taxable activity, the services are treated as having been supplied outside New Zealand. The services are therefore not subject to GST unless the non-resident supplier chooses to treat the services as being made in New Zealand (no agreement is required between the supplier and recipient for this purpose). If the supplier chooses to treat the supply of remote services as being made in New Zealand, the supply will be zero-rated under section 11A(1)(x).

Example 2

Cynthia is a British resident who is looking at buying a holiday home in New Zealand. While still based in her home in London, she seeks general information from a New Zealand-based property valuation firm on the range of prevailing property market values for each region that she is considering in order to determine which potential areas are affordable for her budget. She also engages a New Zealand-based accountancy firm to advise her on the general tax implications of investing in land in New Zealand.

Several weeks later, after returning to London from a short trip to New Zealand to look at potential properties, Cynthia decides to submit a tender (through a real estate agent) for an empty lot of land in the Coromandel, where she intends to construct a holiday home. Before submitting the tender, she engages a New Zealand-based solicitor to provide her with legal advice and undertake the conveyancing work. She again phones the property valuation firm – this time to ascertain the market value of the Coromandel property. After her tender is accepted by the vendor, she hires a New Zealand architect to draw up the building plans.

The supply of property valuation services (relating to the New Zealand housing market generally by region) and the provision of general advice relating to the tax implications of investing in New Zealand property are both zero-rated under section 11A(1)(k). This is because neither of these services are directly connected with land, nor do they have a sufficient nexus with any specific piece of New Zealand land to be "intended to enable or assist a change in the physical condition, or ownership or other legal status" of land in New Zealand.

However, the conveyancing and architectural services, the services provided by the real estate agent and the valuation services specifically relating to the Coromandel property do not qualify for zero-rating under section 11A(1)(k), as the exclusion in paragraph (i) applies. These services are supplied in connection with specific land in New Zealand and are intended to assist or enable a change in the ownership status or physical condition of that land. These supplies are therefore charged with GST at 15%.

Even if Cynthia's tender had not been accepted by the vendor, the legal and valuation services relating to the Coromandel property would, on an objective assessment of Cynthia's intention in respect to the Coromandel property, still be charged with GST at 15% because they are intended to assist a change in the ownership status of the land. Similarly, if Cynthia had decided not to proceed with constructing a building on the site after the plans were drawn up, the architectural services would still be charged with GST at 15% as they are related to specific land and were, at the time of supply, intended to assist a change in the physical condition of the land.

Example 3

Gary is a non-resident who is interested in buying a house in New Zealand. During his search on the internet, he finds 10 different properties of interest. To help compare each property, he places an order through the website of a New Zealand property valuation firm for an electronic set of valuation reports for each property that he is interested in. Each report includes a valuation generated by an electronic algorithm, based on recent sales of properties that are both nearby and comparable to the property for which the valuation is requested.

Although the valuation services do relate to specific land in New Zealand (each valuation report ordered is for a specific title of land), the valuation services cannot objectively be said to be intended to enable or assist a change in the legal nature or ownership status of any of those specific titles of land, as it would be reasonable to assume that Gary does not have a specific intention to purchase all 10 properties. (In this case, the property valuation services would be considered to be too many steps removed from the process of changing the ownership status of any one of those 10 specific properties.) The supply of property valuation services is therefore zero-rated under section 11A(1)(k) (as they would have been under the existing "directly in connection" test).

Example 4

Nehal is an Australian resident who is looking to invest in New Zealand real estate. During his search on the internet, he discovers a large lot of empty land in the Northern Wellington area for sale, which he thinks would be perfect for subdividing and constructing two large multi-storey houses. He hires Tamati, a New Zealand resident, to act as his agent in tendering for the property.

The tender submitted by Tamati for the land is successful, so Nehal begins planning for developing the land. He hires Paul, a New Zealand-resident lawyer based in Wellington to perform the conveyancing and subdivision work. When construction begins, Nehal hires a Wellington-based on-site construction supervisor, Rachel, to ensure that the work is done in accordance with building codes and that all of the necessary documentation is produced. Nehal also engages a Wellington-based structural engineering firm to carry out independent anti-seismic evaluations during the later stages of the construction work to ensure the structural soundness of the two buildings.

GST is charged at 15% on Tamati, Paul and Rachel's services, as well as the services supplied by the engineering firm. Tamati and Paul's services are supplied in connection with land in New Zealand and are intended to enable a change in the legal status of the land. The on-site construction supervision and engineering services are supplied in connection with land in New Zealand and are intended to assist a change in the physical condition of the land or improvements to the land.

Example 5

Aiko is a Japanese resident who is considering investing in commercial property owned by B Co., a New Zealand company which owns a range of other assets in addition to the commercial property. From her office in Tokyo, Aiko engages a New Zealand-based accounting firm that offers audit and assurance services to audit B Co.'s financial accounts. B Co.'s financial statements include the details of the rental yield of the commercial property.

Because the audit services could be used as a means of deriving a valuation of the commercial property owned by B Co., this scenario may appear to be similar to the situation outlined in Example 2 where a real estate valuation for a specific property was obtained with the intention of changing the ownership status of the land in New Zealand. However, the services concerned here are the audit of the company accounts of B Co. (as opposed to being valuation services more directly related to the land owned by B Co.). As such, the services do not have a sufficient nexus with the land to meet the new legislative test for services supplied in connection with land in New Zealand.

The audit services are therefore zero-rated under section 11A(1)(k) (as they would have been under the existing "directly in connection" test).

Example 6

Stig is a Swedish resident who intends to purchase shares in a company, C Co., which owns New Zealand land. Stig engages a New Zealand law firm to perform due diligence services in relation to the land owned by C Co. The due diligence services include title searches, checking lease terms for change of control provisions, and investigating access rights and unregistered third-party interests affecting the land.

While the due diligence services provided by the law firm are supplied in connection with specific land in New Zealand, they are not "intended to enable or assist a change in the … ownership or other legal status" of the land. This is because the acquisition of shares in C Co. by Stig does not change the legal ownership of the land, as the land itself is still owned by C Co. The indirect change in ownership of the land is therefore not sufficient to meet the new legislative test for services supplied in connection with land in New Zealand.

The due diligence services supplied by the law firm are therefore zero-rated under section 11A(1)(k) (as they would have been under the existing "directly in connection" test).

Example 7

Aus Co. is a non-resident company that intends to acquire shares in NZ Co., a company which owns, among other assets, land in New Zealand that is classified as sensitive under the Overseas Investment Act 2005. Aus Co. therefore engages a New Zealand law firm to provide advice on an Overseas Investment Office (OIO) application for consent in relation to the intended acquisition of shares in NZ Co.

The advice provided by the law firm in relation to the application for OIO consent is not intended to enable or assist a change in the ownership or other legal status of the land owned by NZ Co. As in Example 6, the transfer of shares in NZ Co. leads only to a change in the indirect ownership of the land owned by the target company, and not a change in the legal ownership of that land. The supply of advice is therefore zero-rated under section 11A(1)(k) (as it would have been under the existing "directly in connection" test).

Zero-rating of services supplied in connection with land outside New Zealand

Amended section 11A(1)(e) extends zero-rating beyond the existing "directly in connection" test to services that are supplied in connection with land situated outside New Zealand, and which are intended to enable or assist a change in the physical condition, ownership or other legal status of the land.

Example 8

Maraina is looking to purchase an apartment in Brussels so that she can be closer to Melissa, her twin sister. Maraina engages a New Zealand-resident lawyer, Gordon, to act for her in a transaction to acquire an apartment. Gordon's services are in connection with land outside New Zealand and are intended to enable a change in the legal nature of the offshore land. His services are therefore zero-rated under section 11A(1)(e).

Maraina's residency status or location does not affect the application of the rule for services connected with land outside New Zealand.

The following table provides an indication of the usual treatment of some common services under the new GST rules for services connected with land.

Table 1: GST treatment of common services connected with land – some examples

Type or purpose of services	Examples	GST treatment
Intended to enable or assist a change in the physical condition of land	• Construction • Earthworks.	Covered by the existing "directly in connection" test
	• Architectural services • Engineering • Construction supervision.	Covered by the new test
Intended to enable or assist a change in the ownership or other legal status of land	• Real estate services • Legal services, for example conveyancing • Valuation services • Advertising or marketing services.	Covered by the new test
General services not connected to a specific piece of land	• Valuation services for the general property market • General legal services, for example advice on the tax implications of investing in land.	Not covered by the new test
Intended to enable or assist a change in the indirect ownership (as opposed to legal ownership) of land	• Advice on an OIO consent application in relation to land owned by a target company • Due diligence services in relation to land owned by a target company, for example, title searches.	Not covered by the new test

Supplies of land leases

Sections 11(8D) and 20(3K) of the Goods and Services Tax Act 1985

The Goods and Services Tax Act 1985 has been amended to address technical issues with the rules that determine when commercial leases are excluded from the compulsory zero-rating of land rules or when certain other supplies are zero-rated.

In addition, the new rules also extend zero-rating to supplies of land to GST-registered non-profit bodies when the land will be used for a non-profit activity that is neither a taxable nor exempt activity.

Background

Compulsory zero-rating of land transactions

The compulsory zero-rating of land rules apply GST at the rate of 0% to certain supplies of land from a GST-registered supplier to a GST-registered purchaser. Most transactions involving commercial land are captured by the rules. An exception is a commercial lease, which, to reduce compliance costs, is generally excluded under section 11(8D)(b) from zero-rating – unless it involves an irregular, large lump-sum payment, which may suggest that it could be substitutable for a transfer of land.

The new rules clarify when a supply of an interest in land under a commercial lease is excluded from the compulsory zero-rating of land rules or when certain other supplies under a commercial lease (such as lease surrenders and procurements) are zero-rated.

Non-profit bodies

GST-registered non-profit bodies are generally able to recover the GST they incur on goods and services that they acquire, except to the extent that they incur the GST in making exempt supplies. This is because of a deeming rule in section 20(3K) of the GST Act which treats goods and services acquired by a non-profit body as used for making taxable supplies, to the extent that these goods and services are not used for making exempt supplies.

The application of this deeming rule was limited to calculating non-profit bodies' deductions of GST, and technically did not apply for the purposes of the compulsory zero-rating of land rules. Instead of zero-rating, a supply of land to a non-profit body would therefore be charged with GST at 15% when the non-profit body had acquired the land for a non-taxable purpose. To the extent that the non-profit body had not acquired the land for making exempt supplies, the non-profit body was required to recover the GST it incurred.

The amendment for non-profit bodies ensures that the compulsory zero-rating of land rules apply to a supply of land to a GST-registered non-profit body, where the non-profit body uses the land in a non-exempt activity. This ensures that the supply is zero-rated in circumstances where the non-profit body would ordinarily be able to deduct the GST incurred.

An amendment to section 20(3K) provides that any exempt use of the land is taxed under the existing output tax adjustment mechanism in section 20(3J).

The changes ensure that GST-registered non-profit bodies are treated in the same manner as other GST-registered persons in relation to the sale and purchase of land.

Key features

The new rules for commercial leases comprise three changes:

- clarification that a supply from landlord to tenant, as part of a lease surrender arrangement, is zero-rated;
- a reworking of the test for whether an arrangement is a commercial lease, and therefore not a supply of land under the compulsory zero-rating of land rules, so that:
  - it applies to a supply under an agreement that provides for periodic payments, rather than when the land is supplied periodically; and
  - when payments under the lease (other than regular lease payments) are anticipated to be less than or equal to 25 percent of the total consideration payable under the lease, the previous position is retained so that supplies of an interest in land under the lease agreement are not supplies of land under section 11(1)(mb). However, when this 25 percent threshold is exceeded (for example, because the payment is higher than anticipated), the GST treatment of past payments is not affected; and
- clarification that the procurement by a third party of a lease is zero-rated.

The new rule for non-profit bodies ensures that where land is supplied to a GST-registered non-profit body, for use other than in making exempt supplies, the supply is zero-rated under section 11(1)(mb).

The amendments ensure that the rules operate consistently with the policy intent to zero-rate commercial land transactions, by clarifying that certain transactions fall within the rules or by correcting technical issues with the way the rules capture certain transactions.

Application dates

The new rules for commercial land leases apply on and after 1 April 2011, except for new section 11(8D)(c), which deals with lease procurements and applies on and after 30 June 2014 (the date that the former provision came into force). The new rules for commercial leases also preserve existing positions previously taken.

New section 11(8D)(d), which deals with acquisitions of land by non-profit bodies, came into force on the date of enactment, being 30 March 2017.

Detailed analysis

Lease surrender payments

The original policy intent was that the surrender of a lease would be a zero-rated supply of land. While the surrender of the lease was caught by previous section 11(8D)(a), the section did not zero-rate the landlord's surrender of their contractual right to payment. New section 11(8D)(ab) provides that this is treated as a supply of land for the purpose of the compulsory zero-rating of land rules.

Periodic payments

Section 11(8D)(b) sets out the general rule that a supply of an interest in land under a commercial lease is standard rated. An exception applies where a one-off payment or amount payable under the lease exceeds (or is anticipated to exceed) 25 percent of the total consideration payable under the lease. Where this exception applies, the supply corresponding to the payment and all subsequent supplies under the lease are subject to the compulsory zero-rating of land rules.

New section 11(8D)(b) contains two clarifications of the previous provision.

Firstly, the previous provision only applied if a supply of an interest in land was made periodically. However, leases may be subject to various rules around the time of supply. Where a commercial lease provided for periodic payments to be made, depending on the lease terms, payment could have been in relation to a separate supply (and therefore the supply of the interest in land was not made periodically as a single supply). This proviso has been replaced with a requirement that the supplies of an interest in land are made under an agreement which provides for periodic payments.

This clarifies that most commercial leases are excluded from the compulsory zero-rating of land rules, so that a supply of an interest in land under a commercial lease will generally be standard rated, unless the exception for large, irregular payments applies.

Secondly, new section 11(8D)(b) excludes a supply of an interest in land under a commercial lease from the compulsory zero-rating of land rules if payments under the lease which are not regular rent payments are anticipated to be less than or equal to 25 percent of the total consideration payable under the lease. If a payment does in fact exceed this threshold (for example, if it is a contingent payment, or an un-quantified payment), then the payment and future payments under the lease are zero-rated.

This replaces the previous test, which arguably changed the treatment of past supplies under the lease to be zero-rated. The new section clarifies that past supplies made under the lease remain standard rated, where the payments corresponding to those past supplies meet the test for standard rating.

Example

Jared makes regular payments under a commercial lease agreement. These payments are standard-rated and are not subject to the zero-rating rules. At some point, a large, irregular payment is made which exceeds 25% of the consideration specified under the lease agreement. Consequently, the payment is subject to GST at 0%, and all future payments under the lease are also zero-rated.

However, the payment does not alter the GST treatment of the past supplies made under the lease agreement. Therefore, previous payments made under the lease remain subject to GST at 15%.

Procurement of an existing lease

New section 11(8D)(c) clarifies that the procurement by a third party of a lease is zero-rated, whether the previous supplies from the landlord to the outgoing tenant under the existing lease are excluded from zero-rating under paragraph (b) or not. The new rule is intended to apply to arrangements where, by agreement of all the parties, an existing lease between landlord and tenant is replaced with a new lease between the landlord and a new tenant, and the incoming tenant provides consideration to the outgoing tenant. This may occur because the lease could not be assigned.

The amendment is also intended to cover certain situations where a commercial lease is novated. A novation is intended to fall within the scope of the amendment where the tenant is substituted with a third party, so that the third party takes on the tenant's rights and obligations under the existing lease agreement, in the situation where the third party provides consideration to the outgoing tenant. However, the scope of the amendment is not limited to novations, as it also applies to an arrangement which involves a tenant's surrender of a commercial lease and the landlord's supply of the interest in the land to a third party under another lease agreement.

Non-profit bodies

Under new section 11(8D)(d), a GST-registered non-profit body acquiring land is treated, for the purpose of the compulsory zero-rating of land rules, as acquiring the land for the purpose of making taxable supplies, except to the extent that it is acquiring it for making exempt supplies. This means that the non-profit body can provide a section 78F statement, and the supply is completely zero-rated.

Where the non-profit body is using the land partially to make exempt supplies, it will be required to account for output tax under section 20(3J) for the amount of GST it would have incurred that it could not have deducted under the existing rule in section 20(3K).

Consistent with the rule in section 20(3K) allowing registered non-profit bodies to recover GST to the extent that the goods and services are not used for making exempt supplies, the new rule in section 11(8D)(d) only applies to GST-registered non-profit bodies that are resident in New Zealand.

Application of the savings provision

A "savings" provision preserves the past tax positions taken by taxpayers before 30 March 2017 for supplies made after 30 June 2014, where these past tax positions are inconsistent with new section 11(8D).

Six-monthly filing

Sections 15(2), 15C(1), (2) and (2B) of the Goods and Services Tax Act 1985

An amendment to the Goods and Services Tax Act 1985 addresses technical issues with the eligibility to file GST returns six-monthly, and introduces a self-assessed "one-off" exception that replaces the discretion to allow a person to file six-monthly, even if they do not satisfy the threshold.

Background

A GST-registered person's taxable period determines the frequency with which they must file GST returns. Taxable periods must be one month, two months or six months,[9] and certain rules govern when a person may choose or must have a taxable period of a certain length.

A registered person whose taxable supplies exceed or are likely to exceed $24 million in a 12-month period must have a one-month taxable period. Alternatively, any registered person may choose to have a one-month taxable period.

A person who is not required to have a one-month taxable period may have a two-month taxable period or, if their taxable supplies do not exceed and are not expected to exceed $500,000 in a 12-month period, they may choose to file six-monthly.

The table below sets out the general rules for taxable periods by turnover band.

Value of total taxable supplies for a 12-month period (expected or actual)	Taxable period
Less than $500,000	Choice of monthly, two-monthly or six-monthly
$500,000 – $24 million	Choice of monthly or two-monthly (would usually be ineligible to file six-monthly, but special rules may apply)
Over $24 million	Required to file monthly

A person may change their taxable period to a different period, if they meet the necessary criteria, by giving notice to the Commissioner. The change takes effect from the end of the current period.

Under the previous rules, the Commissioner had the discretion to allow registered persons, whose taxable supplies exceeded the $500,000 threshold, to file six-monthly. This discretion has been replaced with a self-assessed test.

9 Non-resident suppliers of remote services to which section 8(3)(c) applies are required to have a three-month taxable period.

The amendment covers technical changes to the rules that govern eligibility to file six-monthly. In particular, the changes:

- ensure that a person is eligible to file six-monthly when they make seasonal supplies, regardless of whether they exceed the turnover threshold;
- clarify that a person who exceeds the turnover threshold for six-monthly filing must change their taxable period; and
- replace the current discretion for six-monthly filing with a "one-off" exception, which enables a business to continue to file six-monthly when the threshold is exceeded.

Key features

Under section 15(2)(a), a person could already have a six-month taxable period when they make or are likely to make no more than $500,000 of taxable supplies in a 12-month period.

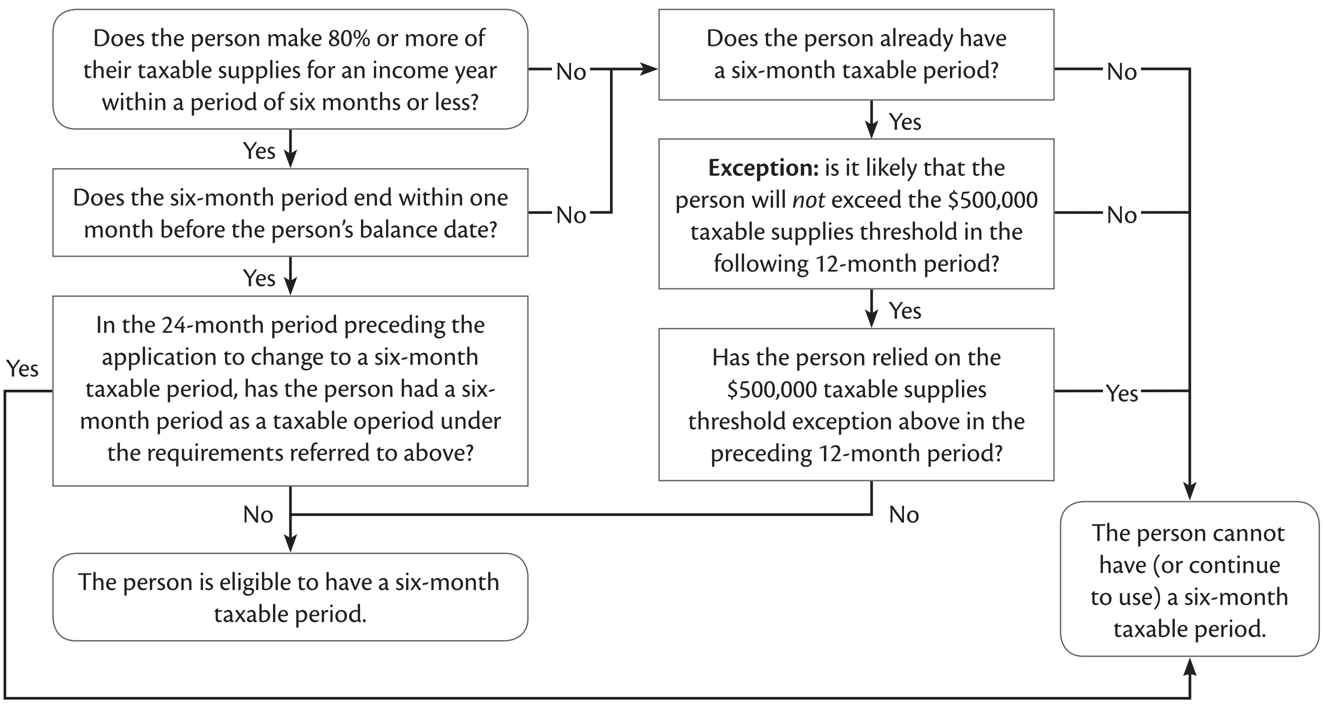
A person is now also eligible under section 15(2)(b) if they make 80 percent or more of their taxable supplies for an income year within a period of six months or less, that ends within one month before their balance date – provided that they have not had a six-month period as a taxable period under this criterion in the two year-period before the application to change to a six-month taxable period.

This last requirement is intended to allow businesses that make almost all of their supplies in a single season, and who prepare their accounts at the end of the season, to file six-monthly.

Amended section 15C(2) requires a person to change their taxable period from a six-month period when they exceed the threshold for six-monthly filing and the exception for seasonal businesses does not apply. The person must change at the end of their next taxable period ending with or after the 12-month period referred to in section 15(2)(a) when they do not meet the criteria. To do so, they will need to apply to file either one-monthly or two-monthly before the end of the current period, so that the change takes effect at the end of the current period.

However, new section 15C(2B) relieves a person of this requirement to change their taxable period where they are unlikely to exceed the threshold in the following taxable period. For this exception to apply, the person must not have relied on this exception in the immediately preceding 12-month period.

The flow chart below sets out the circumstances in which a registered person who makes (or expects to make) total taxable supplies for a 12-month period valued above $500,000 (but not valued more than $24 million) is eligible to be a six-monthly filer.



Application date

The new rules came into force on the date of enactment, being 30 March 2017.

Cross-border business-to-business neutrality remedial amendments

Section 54B of the Goods and Services Tax Act 1985 and section 24BA(1B) of the Tax Administration Act 1994

Amendments have been made to address technical problems encountered by non-resident businesses that do not make taxable supplies in New Zealand in registering under section 54B to claim refunds of GST incurred by them in carrying out their overseas business activities.

Background

Special rules were introduced on 1 April 2014 to enable non-resident businesses to voluntarily register for GST (despite not carrying on a taxable activity in New Zealand) in order to claim GST refunds for goods and services they purchase from New Zealand suppliers.

The rules were intended to help ensure that GST was not a cost for non-resident businesses and better ensure neutrality for cross-border business-to-business supplies relative to similar domestic supplies.

Non-residents are unable to register under section 54B when they are supplying goods or services to final New Zealand consumers (in which case they should instead register under the ordinary GST registration rules in section 51). A number of eligibility requirements are used in section 54B to achieve this.

The "taxable activity" exclusion

Section 54B(1)(d) is designed to prevent non-residents from registering under section 54B if they are conducting a business in New Zealand for which they could register under the ordinary GST registration rules in section 51. However, the original wording of section 54B(1)(d) was broader than the policy intent. It applied to non-residents "carrying on a taxable activity in New Zealand" and may have excluded businesses that had any kind of presence or commercial activity in New Zealand, even though that presence or activity was very minor. The policy objective is only to prevent non-residents from registering under section 54B if they are making taxable supplies, and so are liable to (or able to) register under section 51.

Services received by persons in New Zealand for private consumption

Similarly, section 54B(1)(c) is designed to prevent non-residents from registering under section 54B if their business activity is likely to involve providing services to final New Zealand consumers. This exclusion originally referred to the performance of services received in New Zealand by non-registered persons. However, GST-registered persons can also be final consumers if the services are used privately (rather than for a business use).

Anti-avoidance attribution rule

To prevent non-resident importers from claiming back Customs GST on goods that they deliver to final New Zealand consumers, a special attribution rule was introduced in 2014. This rule applies when a non-resident who is registered under section 54B pays GST to the New Zealand Customs Service in respect of imported goods that are received by or delivered to another person in New Zealand. It deems the Customs GST as being paid by the recipient of the goods rather than the non-resident. This means a recipient that is a GST-registered person can claim an input tax deduction for the Customs GST, but if they are a not registered for GST (for example, a final consumer) the Customs GST cannot be refunded.

A consequence of this attribution rule was that a non-resident who only incurred Customs GST may have been unable to register under section 54B, since the Customs GST would be attributed to the recipient of the goods, meaning that the non-resident could not meet the $500 threshold test to register under the non-resident regime.

Separate branch registration for non-resident businesses with a New Zealand branch

Some non-resident businesses operate through New Zealand branches and have registered their New Zealand branches for GST under section 51. These non-residents were considered to be conducting a taxable activity in New Zealand through their New Zealand branch. This prevented them from registering their head office or an overseas branch, as a separate person to their New Zealand branch, under section 54B.

As a consequence, these non-residents have been unable to recover GST on business costs they have incurred in New Zealand under either the non-resident registration rules or the standard registration rules (as the costs do not relate to any taxable supplies made by their New Zealand branch).

Exception to the bank account requirement for non-residents registering for GST

The Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Act 2016 introduced an exception to the requirement for offshore persons to have a bank account number in order to obtain an IRD number. This exception, in section 24BA(1B) of the Tax Administration Act 1994, was intended to cover non-residents who were applying for an IRD number only because they were registering for GST. However, it was arguable that the wording of the exception may not have covered those who were applying to be registered for GST under section 54B.

An amendment to section 24BA(1B) of the Tax Administration Act clarifies that these non-residents are not required to have a New Zealand bank account number if they require an IRD number only because they are registering for GST.

Key features

The amendments make four changes to the eligibility requirements that allow eligible non-resident businesses to register for GST in order to claim GST refunds for goods and services that incur New Zealand GST:

- Section 54B(1)(d) has been amended so that it excludes non-residents who make (or intend to make) taxable supplies in New Zealand. Non-residents are also prevented from registering under subsection (1)(d) if they make supplies to non-registered persons in New Zealand which would be taxable supplies if the non-resident was instead registered under section 51.
- An amendment to section 54B(1)(c) ensures that a non-resident cannot register under these rules when their activities involve the performance of services that are consumed in New Zealand, including when the consumption involves private use by GST-registered persons.
- An amendment to section 54B(1)(b) allows non-resident goods importers to register so that Customs GST can be recovered under the attribution rule by a GST-registered business who receives the goods.
- New section 54B(4) to (6) provides that when a branch is registered for GST it is treated as a separate person from its head office and any other branches for the purpose of a non-resident person applying under section 54B. This allows an overseas company with a New Zealand branch that is registered under section 51 to treat their New Zealand branch as a separate person and therefore register its head office or an overseas branch for GST under section 54B.

In addition, amended section 24BA(1B) of the Tax Administration Act 1994 clarifies that non-residents are not required to have a New Zealand bank account number if they require an IRD number only because they are applying to register for GST under section 54B.

Application date

The amendments to section 54B(1)(b) and (c) apply on and after 1 October 2016.

The amendment to section 54B(1)(d) and new subsections (4) to (6) apply on and after 1 April 2014.

The amendment to section 24BA(1B) applies on and after 14 May 2016.

Detailed analysis

Excluding non-residents who make (or intend to make) taxable supplies in New Zealand

Section 54B(1)(d) has been amended so it excludes non-residents who make (or intend to make) taxable supplies in New Zealand.

The previous wording of section 54B(1)(d) was broader than the policy intent. It applied to non-residents "carrying on a taxable activity in New Zealand" and excluded businesses that had any kind of presence or commercial activity in New Zealand even though that presence or activity was very minor. The policy objective of paragraph (d) is to prevent non-residents from registering under section 54B only if they are making taxable supplies, and therefore are liable to (or able to) register under section 51. Accordingly, new section 54B(1)(d)(i) excludes non-residents who make taxable supplies in New Zealand.

A taxable supply is a supply of goods and services in New Zealand which is charged with tax under section 8 of the GST Act. This raises the question of whether a person who is not required to register for GST (for example, because the total annual value of their supplies is less than $60,000), but who is applying for non-resident registration under section 54B, would be "intending to make taxable supplies".

Therefore, for the avoidance of doubt, section 54B(1)(d)(ii) excludes non-residents who, if they were registered for GST under section 51, would be making taxable supplies to persons in New Zealand who are not themselves registered for GST (in other words, final consumers). Section 54B(1)(d)(ii) will not apply to disqualify a non-resident if their only supplies to New Zealand persons are to registered persons. This is because, in these cases, requiring the non-resident to register under section 51 and return GST output tax would typically mean any GST collected would be offset by input tax deductions claimed by the GST-registered recipients of the supplies.

This approach is also consistent with section 8(4) and (4D), which would usually deem supplies made by a non-resident to a registered person for use in the registered person's taxable activity to be supplied outside New Zealand.

New section 54B(1)(e) excludes non-residents who are members (or who intend to become members) of a group of companies under section 55 that make taxable supplies in New Zealand. This replaces the rule in former section 54B(1)(d)(ii).

Example 1: Non-resident company intending to make taxable supplies in New Zealand

Video Game Startup Co. (VGS) is a small non-resident video game production company which is developing its very first video game. While the worldwide sales of the game for the first year of its release are expected to be in excess of NZ$60,000, and VGS already has a small number of New Zealand-based customers, VGS does not expect that its sales of the game to New Zealand-resident private consumers will be above the $60,000 GST registration threshold for at least the next two years. Hence, even though the company is supplying a remote service to New Zealand consumers, it does not have a liability to register for GST in New Zealand under the remote services rules.

Therefore, if VGS does not register for GST (or does not become liable to register for GST under section 51(1)), the remote services rules will not apply to impose GST on its supplies to New Zealand consumers. In other words, as a non-registered person, VGS does not make taxable supplies because its supplies are not charged with GST under section 8.

VGS intends to send two of the young animators it employs, Shane and Matt, to an animation conference being held in Auckland. The schedule for the conference includes a number of master class workshops on advanced electronic animation techniques, presented by leading animators in the video games and film industries. The price charged by the organiser for attendance at the conference is inclusive of GST at 15%.

VGS wishes to claim back the GST it incurs on the price of entry into the conference for Shane and Matt. However, VGS is not eligible to register under section 54B because of the exclusion in section 54B(1)(d)(ii): VGS makes supplies of remote services to New Zealand consumers which, if VGS was a GST-registered person, would be charged with GST.

Preventing non-residents from registering under section 54B when they on-sell services which are consumed by GST-registered persons as private use

New section 54B(1)(c) replaces the current requirement with updated wording. Section 54B(1)(c) prevents a person who on-sells services that will ultimately be consumed in New Zealand from registering under the non-resident registration rules.

Previously, section 54B(1)(c) prevented registration when it was reasonably foreseeable that the services would be received in New Zealand by a person who was not a registered person. The new section will prevent registration when the person receives the services other than in the course of making taxable or exempt supplies.

The amendment therefore ensures that a non-resident cannot register under section 54B if it is reasonably foreseeable that any services they on-sell will be consumed as private use by a GST-registered person who is in New Zealand at the time the services are performed. The new wording of section 54B(1)(c) is aligned with section 11A(2), which addresses a similar concern.

This clarifies that a private expense incurred by a business cannot be claimed back under the special non-resident registration rules.

Allowing non-resident goods importers to register so that Customs GST can be recovered by a GST-registered business that receives the goods

Before 30 March 2017 (the date of enactment), section 54B(1)(b) required a non-resident's first input tax credit claim to exceed $500 in order for the non-resident to be able to register under section 54B.

In addition to including non-residents who can claim at least a $500 refund, new section 54B(1)(b) will alternatively be satisfied if the non-resident business is likely to be liable for GST levied by the New Zealand Customs Service (under section 12(1) of the GST Act) in relation to the importation of goods that are received by another person or that the non-resident delivers to another person.

This addresses a situation where GST could be incurred by a non-resident that only has a very minor activity or presence in New Zealand and who operates as an importer. A special attribution rule in section 20(3LB) and (3LC) currently treats any GST paid to the New Zealand Customs Service on the import of goods, by a non-resident registered under section 54B, as being incurred by the recipient of the goods. This ensures that the rules cannot be used to avoid the taxation of goods consumed in New Zealand.

Prior to the amendment, a side effect of this attribution rule was that a non-resident who only incurred Customs GST may have been unable to register under section 54B, since the Customs GST would be attributed to the recipient of the goods and therefore the non-resident could not meet the $500 threshold test. Furthermore, as they could not actually register under section 54B, the attribution rule did not apply to allow the recipient of the goods to claim the GST. As a result, neither the recipient of the goods nor the non-resident importer could recover this GST cost.

The amendment allows the non-resident in this situation to register under section 54B, so the attribution rule can apply as intended. In such cases the non-resident would typically file nil GST returns (unless they also had inputs that were subject to New Zealand GST), as they would be unable to claim a refund for the Customs GST in their GST return.

Example 2: Allowing non-resident goods importers to register

Fancy Leather Boots Co. (FLB) is a non-resident company that imports high-end luxury footwear into New Zealand and arranges for the footwear to be delivered to New Zealand customers. A small number of FLB's New Zealand customers are GST-registered retailers who order bulk shipments of luxury leather boots and on-sell the boots to final consumers, while a larger proportion of FLB's customers are private consumers ordering the boots directly from FLB's online store.

When a private New Zealand consumer orders boots from FLB's online store, the goods are held in a warehouse in Australia until payment for the goods is received. Upon receipt of payment, the goods are released and imported into New Zealand by an agent acting for the company. In the case of FLB's regular New Zealand business customers, an invoice is issued to the customer shortly after the order is placed and the goods are moved from the warehouse and imported into New Zealand by the agent. When the supply of the goods is to a consumer, the supply will not be a taxable supply because the goods are outside New Zealand at the time of supply.

Even if an invoice is issued to a GST-registered business customer after the goods are already in New Zealand, the supply will not be a taxable supply as section 8(4) will apply to treat the supply as made outside New Zealand.

FLB will also satisfy the new section 54B(1)(b) criterion, as they will be liable as an importer to pay GST to the New Zealand Customs Service on the boots that they import into New Zealand. However, if they become registered under section 54B, FLB will not be able to claim refunds of the Customs GST levied on the importation of goods that are received by or delivered to another person in New Zealand. This is because of the attribution rule in section 20(3LB) and (3LC), which treats the Customs GST as having been paid by the recipient of the goods.

This means that GST-registered businesses that FLB supplies to will be able to claim an input tax deduction for the Customs GST charged on the importation of the boots (to the extent that they will use these goods for making taxable supplies). However, non-registered persons (and other persons receiving the goods in a solely private consumption capacity) cannot claim back the Customs GST.

Allowing non-residents with a New Zealand branch to register as a separate person to their New Zealand branch

New sections 54B(4) and (5) provide that when a branch is registered for GST it is treated as a separate person from its head office and any other branches for the purpose of a non-resident person applying under section 54B. This allows an overseas company with a New Zealand branch that is registered under section 51 to treat their New Zealand branch as a separate person and therefore register its head office or an overseas branch for GST under section 54B.

This allows a non-resident head office or branch to recover GST on business costs they have incurred in New Zealand, since the standard registration rules in section 51 do not allow these non-resident businesses to claim back GST on costs which do not relate to any taxable supplies made by their New Zealand branch.

New section 54B(6) clarifies that the requirement for consistent taxable periods and accounting bases under section 56(6) does not apply in the context of non-resident businesses registering separately from their New Zealand branch under section 54B. This means that non-residents who register under section 54B are not required to have the same taxable period and accounting basis as their New Zealand branch or division.

Example 3: Non-resident company with a New Zealand-based branch

Dairy Co. is an Australian-incorporated company which has a New Zealand-based branch. The New Zealand-based branch of Dairy Co. is registered for GST under section 51.

The Australian head office of Dairy Co. sends a number of its new Australian employees to a dairy factory in New Zealand (owned by its sister company, Milk and Cheese Co.) each year to receive training in operating a dairy factory. The Australian head office of Dairy Co. can register separately under section 54B from its New Zealand branch to claim back the GST incurred on training staff for its Australian-based business activities, as the training services purchased by the Australian head office do not relate to the taxable activity of its New Zealand branch.

Exception to bank account requirement for non-residents registering for GST

It is arguable that the wording of the former exception to the New Zealand bank account number requirement for offshore persons in section 24BA(1B) of the Tax Administration Act 1994 may not have covered all groups of non-residents applying to register for GST.

The amendment clarifies that non-residents are not required to have a New Zealand bank account number when they apply for a tax file number only because they are registering for GST – regardless of whether they are applying to register under the usual registration rules in section 51 or under the non-resident registration rules in section 54B.

GST on remote services and zero-rating of arranging services

Sections 8B(1), (5), 11A(1)(j), (jb), (jc), (1C), 24(5B) and (5D)

An amendment ensures that services that arrange "on the spot" services physically performed offshore are zero-rated, consistent with the rule that existed before the introduction of the Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Act 2016.

In addition, a new rule ensures that when a supply of remote services made by a GST-registered New Zealand-resident supplier to a resident consumer through a non-resident marketplace is treated as two separate supplies, the supply from the underlying resident supplier to the operator of the marketplace is zero-rated.

Background

Facilitation services that arrange services physically performed offshore

The Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Act 2016 applied GST to remote services supplied to New Zealand residents.

Before the GST on remote services rules came into force, section 11A(1)(j) zero-rated services that are physically performed outside New Zealand or which arrange services that are physically performed outside New Zealand. With the introduction of the new rules, it was necessary to exclude remote services from the zero-rating rule in section 11A(1)(j) in order to make those new rules effective (the remote services which the changes were designed to target are "physically performed outside New Zealand"). This amendment ensured that all remote services supplied to New Zealand-resident consumers are standard-rated, rather than zero-rated under section 11A(1)(j).

However, when a registered person supplied a New Zealand resident with an arranging service for an ultimate service that is physically performed outside New Zealand, the amendment resulted in the arranging service (which falls within the definition of a "remote service"[10]) being standard rated, rather than zero-rated as it had been previously. In contrast, the ultimate service would still be either zero-rated (or not subject to New Zealand GST at all if the supplier was a non-resident) if it was not itself a remote service.

The amendment ensures that supplies of facilitation or arranging services which arrange services that are not themselves remote services and that are physically performed outside New Zealand are zero-rated. This treatment applies irrespective of whether the supplier of the arranging service is a resident or a non-resident.

Supplies of remote services from underlying suppliers to non-resident marketplaces

The Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Act 2016 inserted new sections 60C and 60D into the Goods and Services Tax Act 1985. These new sections treat supplies of remote services made by underlying suppliers to New Zealand residents through an "electronic marketplace", or an "approved marketplace" operated by

[10] A "remote service" is a service that, at the time of the performance of the service, has no necessary connection between the place where the service is physically performed and the location of the recipient of the services.

a non-resident, as made by the non-resident marketplace operator. This imposes the liability to account for and return GST on these supplies on the operator of the marketplaces (unless, under certain conditions, the underlying supplier and the operator of the marketplace have agreed the supplier is liable for returning the GST).

The marketplace rules were accompanied by the introduction of new section 60(1C). This subsection (subject to the agreement of the underlying supplier and the marketplace operator) treats a supply of remote services made through a non-resident marketplace to a New Zealand resident by an underlying New Zealand-resident supplier as two separate supplies: the first supply being from the underlying supplier to the marketplace operator, and the second supply being from the operator of the marketplace to the recipient of the services.

This rule was intended to allow underlying GST-registered suppliers who are resident in New Zealand to recover input tax incurred by them in making their supplies of remote services to final consumers through a marketplace. It was initially thought that the supply to the marketplace by the underlying supplier would be zero-rated under section 11A(1)(k) (as the supply is made to a non-resident who is outside New Zealand). However, the supply may not be zero-rated under section 11A(1)(k) because of the rule in section 11A(2), which prevents supplies of services from being zero-rated under section 11A(1)(k) or (l), where it is reasonably foreseeable that the performance of the services will be received in New Zealand by another person in a private consumption capacity.

The amendment ensures that when a resident underlying supplier and a non-resident marketplace operator elect to treat a supply of remote services as two separate supplies, the supply from the underlying supplier to the marketplace is zero-rated. This reduces compliance costs for non-resident marketplaces, as they will not be required to file a full GST return to claim a deduction for the GST charged by the underlying supplier. Instead, the marketplace operator can file a simplified "pay only" GST return with the supply between the two registered persons remaining GST-neutral.

Key features

Consistent with the amendment made to section 11A(1)(j) in the Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Act 2016, new section 11A(1)(j) zero-rates services that are physically performed outside New Zealand and which are not remote services supplied to a New Zealand resident who is not a registered person. This ensures that "on the spot" services that are physically performed overseas continue to be zero-rated.

New section 11A(1)(jb) zero-rates facilitation services that arrange underlying services that are physically performed outside New Zealand and are not remote services supplied to a New Zealand-resident who is not GST-registered. The combined effect of new subsections (1)(j) and (jb) is therefore to:

- standard-rate remote services supplied to New Zealand-resident consumers, provided that these remote services do not constitute the arranging of "on the spot" services that are physically performed outside New Zealand (so services that arrange a supply of remote services received by a New Zealand-resident consumer continue to be standard rated); and
- zero-rate services that arrange "on the spot" services that are physically performed offshore, in line with the treatment for arranging services that existed before 1 October 2016.

When a resident underlying supplier and an operator of a marketplace agree to treat a supply of remote services made through a marketplace as two separate supplies under section 60(1C), new section 11A(1)(jc) applies to zero-rate the supply from the underlying supplier to the operator of the marketplace.

Application date

The new rules apply on and after 1 October 2016.

Detailed analysis

Zero-rating of arranging services

New section 11A(1)(jb) zero-rates services that arrange underlying services physically performed outside New Zealand, provided that those underlying services are not remote services supplied to a New Zealand resident who is not GST-registered.

Example 1

A New Zealand-resident consumer uses the website of a ticketing agent to purchase a ticket for a concert in London. The ticketing agent charges an explicit processing fee, separately from the price of the concert ticket itself. The ticketing agent's services are zero-rated, as they arrange underlying, non-remote services that are physically performed outside New Zealand. The processing fee is therefore subject to GST at 0%, which follows the GST treatment of the underlying supply of admission to the concert.

New subsection (1C) clarifies that the services that arrange the underlying services may include more than one supply, provided these supplies are all made to facilitate the supply of the underlying (non-remote) services.

Example 2

Marie, a New Zealand-resident consumer, uses the booking website of a New Zealand-based travel agent, NZ Co., to arrange the booking of hotel accommodation and a rental car for a holiday in Melbourne. NZ Co. sub-contracts with a non-resident travel agency, Aus Co., to arrange the booking of the rental car for Marie.

NZ Co.'s services, including arranging for Aus Co. to arrange the hire of the rental car, are zero-rated, as they involve the arranging of underlying, non-remote services that are physically performed outside New Zealand under section 11A(1)(jb). The booking fee charged by NZ Co. is therefore subject to GST at 0%, which follows the GST treatment of the underlying supplies of car rental and hotel accommodation services.

Similarly, if Aus Co. is a registered person, their supply of arranging services to NZ Co. will either be treated as made outside New Zealand and will not be subject to New Zealand GST under section 8(4D), or will otherwise be zero-rated if Aus Co. chooses to treat the supply as made in New Zealand.

Zero-rating supplies from underlying suppliers to marketplace operators

New section 11A(1)(jc) applies in the situation where a resident underlying supplier and an operator of a marketplace agree to treat a supply of remote services made through a marketplace as two separate supplies under section 60(1C). Under section 11A(1)(jc), a supply of remote services to a marketplace by the underlying supplier is zero-rated.

This reduces compliance costs for non-resident marketplaces, as they are not required to file a full GST return to claim a deduction for the GST charged by the underlying supplier (as the GST charged on the supply is at the rate of 0%). Instead, the marketplace operator can file a simplified "pay only" GST return.

Example 3

Software App Co., a New Zealand-resident app developer registered for GST, sells its app to customers through an electronic marketplace operated by a non-resident, Online Marketplace Co. When the app is sold to persons who are resident in New Zealand, Online Marketplace Co. is liable for returning the GST.

Software App Co. incurs GST on its purchases of goods and services used in developing and marketing the app, which the company would like to recover. Software App Co. and Online Marketplace Co. agree to treat the supplies of the app made through the electronic marketplace as two separate supplies, the first supply being from Software App Co. to Online Marketplace Co. and the second supply being from Online Marketplace Co. to the purchaser of the app. The supply from Software App Co. to Online Marketplace Co. is zero-rated under section 11A(1)(jc).

This means that Software App Co. can claim back the GST on its inputs used in making the supply to Online Marketplace Co. through an input tax deduction. Because the supply is zero-rated, Online Marketplace Co. does not incur input tax in respect of the supply from Software App Co. Therefore, the GST treatment of the supply from Software App Co. will not be a disadvantage to Online Marketplace Co. if they are registered for GST under the simplified "pay only" registration system for non-resident suppliers of remote services.

Changes to cross-references for remote services provisions

Amendments have been made to sections 8B(1), (5), 24(5B) and (5D) to correct cross-references to other sections.

Section 8B(1) and (5) has been amended so it refers to section 60D, in addition to the existing reference to section 60C.

Sections 8B(5), 24(5B) and (5D) have been amended so they now correctly refer to section 8(4D), instead of section 8(4).

Goods and services connected with exported boats and aircraft

Sections 11(1)(k), (8) and 11A(1)(ib) of the Goods and Services Tax Act 1985

The Goods and Services Tax Act 1985 has been amended to align the GST treatment of goods and services provided in relation to newly purchased boats and aircraft that are to be exported under their own power, with the treatment provided for temporarily imported boats or aircraft.

Supplies of goods that are incorporated into, or are consumed as part of a process of modifying to-be-exported boats or aircraft, are now zero-rated. Similarly, services provided directly in connection with these boats or aircraft are also zero-rated.

Background

In addition to the zero-rating of goods that are entered for export by the supplier, a boat or aircraft may be zero-rated if it is supplied to a person who exports it under its own power to a place outside New Zealand. Export must take place within 60 days of the recipient taking possession, although this may be extended when circumstances outside the control of the supplier and recipient prevent export within this timeframe.

Supplies of goods that are incorporated into temporarily imported goods, or services provided directly in connection with such goods, are also zero-rated as they are expected to be consumed outside New Zealand when the good is re-exported.

Before the amendments, zero-rating did not strictly apply to supplies of goods that were incorporated into boats and aircraft that were exported under their own power, nor to services supplied directly in connection with to-be exported boats and aircraft. However, supplies of goods and services which were provided in respect of temporarily imported boats and aircraft were zero-rated.

This led to potentially different treatments applying, based on whether a boat or aircraft had been purchased in New Zealand and exported overseas, or whether it was brought in as a temporary import, before leaving New Zealand again.

Key features

The amendments comprise three key features.

Section 11(1)(k) has been amended to zero-rate supplies of goods that are supplied in the course of repairing, renovating, modifying or treating to-be exported boats and aircraft. To qualify for zero-rating, the goods must be incorporated into the boat or aircraft, or be used up or become worthless as a direct result of servicing the boat or aircraft.

New section 11A(1)(ib) likewise zero-rates services that are supplied directly in connection with these boats and aircraft.

This aligns the treatment of goods and services supplied in close connection with newly supplied boats and aircraft with similar goods and services supplied in close connection with temporarily imported boats and aircraft.

New section 11(8) allows persons who cannot export the boat or aircraft within the prescribed 60-day timeframe to apply for an extension if the inability to export the boat or aircraft within the prescribed period relates to circumstances beyond the control of the supplier and the purchaser (the previous rule), or if the failure to export the boat or aircraft within the 60-day period is a result of the recipient acquiring goods incorporated into the boat or aircraft or services supplied directly in connection with the boat or aircraft.

Application date

The new rules came into force on the date of enactment, being 30 March 2017.

Adjustments and exported goods

Section 21(2)(ab) of the Goods and Services Tax Act 1985

The Goods and Services Tax Act 1985 has been amended so that non-residents who claim input tax deductions for GST charged on the importation of goods are no longer required to make adjustments to the claimed deductions.

Background

Under the Goods and Services Tax Act 1985, registered persons may recover input tax incurred on goods and services to the extent that the goods and services are used to make taxable supplies. This use must be periodically reviewed, and when the use differs from the estimated use or a previous adjustment, the registered person may be able to claim a further deduction or must repay some or all of a claimed deduction.

NEW LEGISLATION

Some supplies are neither taxable nor exempt, but are simply outside the New Zealand GST base. For instance, goods supplied by non-residents fall outside of the GST base when the goods are situated outside New Zealand at the time of supply.

Under previous settings, this potentially led to an issue when a GST-registered non-resident imported goods for sale in New Zealand and paid GST to the New Zealand Customs Service. In some instances, the importer may have been able to deduct this GST. However, if the goods were not sold in New Zealand and were instead re-exported for sale overseas, arguably the goods may have been effectively taxed under the adjustment rules by the claw-back of the claimed deductions.

Key features

New section 21(2)(ab) applies when:

- a non-resident incurs GST under section 12(1) on the importation of goods; and
- the non-resident subsequently re-exports the goods in or before the adjustment period, and disposes of them overseas or holds them overseas.

This relieves the non-resident from the need to make adjustments to a claimed deduction, and therefore allows them to retain the claimed input credit.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

Grouping limited partnerships

Section 55(8) of the Goods and Services Tax Act 1985

An amendment to the Goods and Services Tax Act 1985 ensures that limited partnerships can apply the grouping rules and file a joint return with other registered persons who share common control.

Background

Under the current rules, groups of registered persons can make an election to file a joint return for GST purposes. The effect of forming a group is that a representative member is treated as making or receiving all supplies that were made or received by the other members. The representative member files a return that includes all of the members' supplies. All members are liable for the joint return.

There are two alternative tests for determining eligibility to form a group. Companies may form a group if they are a group or part of a group of companies under section IC 3 of the Income Tax Act 2007 (subject to other requirements). Alternatively, a group of persons that does not comprise companies only may form a group if a common control test is satisfied.

Limited partnerships are treated as companies for the purpose of the Goods and Services Tax Act 1985, but are generally not companies for the purpose of the Income Tax Act 2007. This led to a situation where a group of registered persons comprising limited partnerships and companies could not form a group because:

- they would not be a group of companies, or part of a group of companies under the Income Tax Act 2007, as they included limited partnerships; and
- each member of the group was a company for GST purposes, so they could not apply the alternative test.

Key features

The amendment allows a group of persons comprising a limited partnership and other limited partnerships and/or companies to apply the common control test to form a GST-registered group.

The common control test is satisfied if:

- one of the members controls each of the other members;
- one member controls all of the members; or
- two or more members carrying on a taxable activity in partnership control all of the other members.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

Value of entertainment expenses

Section 21I(4)(a) of the Goods and Services Tax Act 1985

An amendment to the Goods and Services Tax Act 1985 makes it clear that the amount of a denied income tax deduction for entertainment expenses required to be included in a registered person's GST return is exclusive of GST.

Background

Certain entertainment expenses may not be fully deductible under the Income Tax Act 2007. This recognises that the entertainment may also confer a private benefit on the recipient. GST is imposed on this private consumption element by section 21I(4) of the Goods and Services Tax Act 1985.

Under the previous rules, section 21I(4) treated an amount equal to the denied income tax deduction as consideration for a taxable supply. This was problematic because the denied income tax deduction is a GST-exclusive amount, while consideration is a GST-inclusive term.

The amendment to section 21I(4) treats the amount of the denied income tax deduction as the value of the supply (a GST-exclusive amount) so that the section applies as intended.

Application date

The amendment comes into force on 1 April 2018.

Racing and prizes

Sections 5(11CB), (11CC) and 10(14) of the Goods and Services Tax Act 1985

New section 5(11CB) treats a prize received by the owner of a horse or greyhound as consideration for a supply of services provided to the racing club or racing code. The new section applies when a registered person is carrying on the racing in the course of a taxable activity. As such, it is intended to codify the industry practice of treating winnings paid to registered owners of a horse or greyhound as consideration for a taxable supply. It is not intended to change any interpretation of what constitutes a taxable activity.

Section 10(14) has been amended so that a supply under new section 5(11CB) does not change the calculation of the consideration payable under the formula. The formula in section 10(14) determines the consideration for a prize competition, based on the amounts received less the prizes paid in money.

Treating the prize as consideration for a supply means that the prize can be increased by the amount of the GST, without any economic change in the amount received by the winner or cost incurred by the racing club. The "prizes paid" amount is decreased by the input tax deductible by the organiser, so that the amendment does not unintentionally affect the calculation of consideration under the formula.

Application date

The amendment applies on and after 1 April 2012.[11] A "savings" provision also clarifies that the amendment does not apply in circumstances when a registered person did not include the supply in a return for a taxable period ending before the date of enactment (30 March 2017) consistently with the wording of the amendment. This ensures that reassessments are not inadvertently required as a result of the retrospective application date for the changes.

Bodies corporate

Section 21HC of the Goods and Services Tax Act 1985

The application period of a "savings" provision introduced by the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2016 has been extended. The provision preserved tax positions taken by GST-registered members of an unregistered body corporate to claim deductions for GST incurred by the body corporate.

The savings provision applies to supplies acquired by the body corporate on or before 26 February 2015, and in a taxable period ending on or after 1 November 2010.

A small number of businesses are understood to have technically fallen outside the original provision. The amendment extends the application period of the savings provision to include taxable periods ending before or including 3 November 2015 (the

[11] As currently drafted, the application date for the amendment to section 10(14) may not be entirely clear. An amendment may need to be made to clarify the application of the amendment. The application date of any amendment is likely to be 1 April 2012.

date the savings provision was introduced by Supplementary Order Paper) and beginning after 1 November 2010. This will help ensure that their positions are also preserved by the provision so that all payments received by bodies corporate are treated in a consistent manner.

Application date

The amendment applies on and after 1 October 2011.

Other GST amendments

Secondhand goods and variation of price

Section 25AB of the Goods and Services Tax Act 1985

An amendment ensures that the rules dealing with changes in the consideration for a supply of secondhand goods apply correctly to deductions claimed by a GST-registered purchaser of secondhand goods.

When the terms of a contract for the supply of goods or services are varied (for example, by a discount being subsequently offered), the supplier may be required to issue a debit or credit note to the recipient if the supply is taxable. This triggers obligations on both the GST-registered supplier and a GST-registered purchaser to correct their tax position.

This requirement did not work well when a supply of secondhand goods was not a taxable supply. Although a secondhand goods deduction was available for a GST-registered purchaser (to the extent that they used the goods for making taxable supplies), the debit and credit note rules did not clearly apply to correct the purchaser's GST position where the consideration for the goods changed.

New section 25AB ensures that the rules apply correctly to supplies of secondhand goods. The section applies to a supply of secondhand goods to a registered person when the GST-registered purchaser claimed a secondhand goods deduction, and the amount of the claimed deduction exceeds the correct amount as a result of one of the following events:

- the supply has been cancelled;
- the nature of the supply has been fundamentally varied or altered;
- the previously agreed price of the goods changes, whether through the offer of a discount or by other means; or
- the goods (or part of those goods) supplied have been returned to the supplier.

Under these circumstances, section 25AB requires the purchaser of the goods to return the excess amount of the deduction claimed as output tax for the taxable period in which one of the events referred to above occurred, when the supplier does not provide a tax invoice or a debit note in relation to the supply.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

Alignment of the time period to repay overpaid GST

Section 45(4) of the Goods and Services Tax Act 1985

An amendment allows the Commissioner to refund an amount of overpaid tax within a four-year period following the expiry of the original four-year period in which overpaid tax must be refunded.

The amendment applies when the application is received in or before the second four-year period, and the overpayment is due to a clear mistake or simple oversight. The Commissioner must be satisfied that the amount represents an excess over the amount properly payable for the relevant taxable period.

Application date

The amendment applies for taxable periods beginning on or after 1 April 2005.

Time of supply when consideration is unknown

Section 9(6) of the Goods and Services Tax Act 1985

An amendment provides a method for suppliers to account for GST on supplies of goods and services when the consideration payable (and therefore the amount of GST that must be accounted for) is not known at the time of supply.

The amendment treats a supply of goods and services where the total consideration is not known at the time of supply as more than one supply. A supply is treated as being made when payment is made or an invoice is issued. This enables the supplier to account for GST to the extent that the consideration is or becomes known, extending the existing rule in section 9(3) for periodic payments and progressive supplies.

Application date

The amendment came into force on the date of enactment, being 30 March 2017, and also applies to supplies made before that date, where a registered person previously accounted for GST consistently with the new rule.

Agents acting for purchasers

Sections 26(4) and 60(2B) of the Goods and Services Tax Act 1985

Amendments allow agents and principals to opt out of the agency rules for a supply made to the principal. Opting out enables the parties to account for GST as though the supply were two supplies: from the supplier to the agent, and from the agent to the principal (purchaser).

The agent and principal would need to agree in writing to treat a supply, or class of supplies, in this way.

New section 26(4) prevents a bad debt deduction being claimed for the supply by an agent to a principal. This prevents the claiming of double deductions.

Application date

The amendments came into force on the date of enactment, being 30 March 2017.

Sales under a security interest where an incorrect statement is provided

Sections 5(2)(a) and 51B(1)(b) of the Goods and Services Tax Act 1985

An amendment clarifies that a person who has granted a security over a good, which is sold by the security holder in satisfaction of a debt, and provides an incorrect statement to the security holder, is liable to return GST on the supply themselves.

Under existing law, when a person exercises a power of sale over another person's (the debtor's) goods under a security, they are required to return GST on the supply unless they either:

- receive a statement from the debtor setting out, in full, the reasons why the supply would not be a taxable supply if the debtor supplied the goods themselves; or
- determine, relying on reasonable information they hold, that the supply would not have been a taxable supply.

The Court of Appeal's judgment in *Commissioner of Inland Revenue v Edgewater Motel Ltd* [2003] 1 NZLR 425, at [14], confirmed that when an incorrect statement is provided, the position is reversed, and the debtor is liable to return GST on the supply.

The amendment makes technical changes to the legislation consistent with this judgment, to clarify that the debtor is liable where the security holder does not return GST on the supply (for example, due to an incorrect statement).

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

Deemed supply of financial products upon deregistration

Section 5(3C) of the Goods and Services Tax Act 1985

An amendment ensures that financial products are treated in the same way upon deregistration as if the person actually disposed of them, and are not inadvertently taxed.

A registered person who deregisters is treated as supplying all the goods and services forming part of the assets of their taxable activity in the course of that taxable activity, immediately before they cease to be registered. This ensures that a person cannot achieve a better result by deregistering before disposing of the assets, and that the consumption of the goods and services is taxed.

In certain circumstances, a financial asset might form part of the assets of a taxable activity. For example, when a supply has been made – but the purchaser has not yet made payment – the resulting debt security may be an asset of the taxable activity.

Normally the supply of a debt security would be an exempt financial service, on the transfer of ownership of the security. However, there is no transfer of ownership upon deregistration. Under previous settings, this resulted in the security being taxed.

The amendment ensures that, if a transfer of the ownership of the security would be an exempt supply of a financial service, the deemed supply on deregistration is treated as a transfer of ownership to ensure that the same outcome is reached.

Application date

The amendment applies on and after 1 October 1986.

Financial services and options

Section 3(1)(kaa) and (ka) of the Goods and Services Tax Act 1985

In 2000 an amendment was made under section 3(1)(kaa) to treat the supply of a financial option as a financial service. However, there were two shortcomings:

- the section applied to the provision of an option, but not to the assignment; and
- the payment of an amount arising under a financial option was not included as a financial service under section 3(1)(ka), in the same way as payments relating to other financial products.

The amendment ensures that the transfer of ownership of a financial option or payment of an amount arising under a financial option is also treated as a financial service.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

No apportionment for de minimis exempt use

Section 20(3D) of the Goods and Services Tax Act 1985

A registered person may claim deductions for all input tax they incur, subject to the need to apportion the deduction to reflect non-taxable (exempt and private) use. Section 20(3D) provides an exception to this when a person makes incidental exempt supplies in carrying on their taxable activity. This has been a longstanding approach, and was previously embedded in section 21(4) before the new apportionment rules came into force on 1 April 2011.

Under the previous section 21(4), it was clear that the rule removed the need to make adjustments for only exempt supplies (rather than, for example, private use). An amendment to section 20(3D) makes this effect explicit again.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

Output tax by purchaser who acquires zero-rated land

Section 20(3J)(a)(iii) of the Goods and Services Tax Act 1985

When a person acquires land that is zero-rated under section 11(1)(mb), they are required under section 20(3J)(a)(iii) to account for output tax to the extent that the land is not used for making taxable supplies. This ensures the same result as if they instead incurred GST on the acquisition of the land and apportioned the deduction.

GST is normally charged as output tax on supplies made by a registered person. The amendment to section 20(3J)(a)(iii) clarifies that the amount calculated by multiplying the nominal GST component of the consideration for the supply of land by the percentage of non-taxable use is treated as output tax under section 20(4).

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

GST group filing – liability of departing member for unpaid tax

Section 55(7)(g) of the Goods and Services Tax Act 1985

Section 55(7)(g) provides that when a person is a member of a GST-registered group, they are jointly and severally liable for tax payable by the representative member of the group. Section 57(3) performs a similar function for members of an unincorporated body.

While in both cases a person will remain liable for an amount owed by the representative member while they were a member of the group or unincorporated body, the wording of section 57(3) was clearer than former section 55(7)(g).

Amended section 55(7)(g) is aligned more consistently with the wording of section 57(3), so that this outcome is more apparent.

Application date

The amendment came into force on date of enactment, being 30 March 2017.

Cross-references

Sections 6(5), 20(3)(e), (4)(c) and 21D(3)(b)

A number of incorrect or redundant cross-references in the Goods and Services Tax Act 1985 have been updated or removed:

- The reference to section 6(4) in section 6(5) has been removed, as it is unnecessary.
- Section 20(3)(e) and (4)(c) has been updated to refer to section 21FB.
- Section 21D(3)(b) has been amended so that it now correctly refers to section 20(4) instead of section 21A.

OTHER POLICY MATTERS

Kaikoura earthquake relief measures

Sections EZ 23BC; EZ 78 and EZ 79 of the Income Tax Act 2007

The amendments provide tax relief on depreciation clawback arising from insurance proceeds when a business replaces assets destroyed, demolished or lost as a result of the Kaikoura earthquake and its aftershocks. These provisions provide depreciation roll-over relief on substantially similar terms to that made available to businesses affected by the Canterbury earthquakes. The additional complexity with the roll-over relief for assets affected by the Kaikoura earthquake comes from having two earthquake affected zones (the top of the South Island and the bottom of the North Island).

Key features

Firms in certain circumstances will be allowed to defer (or roll over) depreciation recovery income liabilities arising from the receipt of insurance or compensation payments for irreparably damaged, lost or abandoned items of depreciable property (not including intangible depreciable property) due to the Kaikoura earthquake and its aftershocks. This relief also applies for items of depreciable property that are no longer fit for their original purpose, but may be used by a business for another purpose.

The term "Hurunui/Kaikoura earthquakes" is defined broadly in section 4 of the Hurunui/Kaikoura Earthquake Recovery Act 2016 as "the earthquakes that occurred on 14 November 2016 in Hurunui/Kaikoura, and includes any earthquake that occurs in, or significantly affects, the earth-quake area on or after 14 November 2016".

Application date

These changes apply from the beginning of the taxpayer's 2015–16 and later income years.

Detailed analysis

Depreciation roll-over relief – section EZ 23BC

In the context of the Kaikoura earthquakes and insurance recoveries, the Government decided it is appropriate to provide taxpayers with the ability to defer depreciation recovery income liability in certain circumstances.

Roll-over relief is in the context of the Kaikoura earthquakes provided by section EZ 23BC. This section is intended to apply to items of depreciable property, other than depreciable intangible property. The legislation is more complex than the rules that applied to property affected by the Canterbury earthquakes. The additional complexity is partly due to providing relief for a wider area.

Briefly, section EZ 23BC is intended to apply to items of depreciable property when:

- a person receives insurance or compensation for items of affected depreciable property, which has either been lost, irreparably damaged or made unsuitable for its original use, as a result of the Kaikoura earthquakes, in an income year before their 2019–20 income year, for one of the following classes:
  - items of plant and equipment;
  - items of commercial fit-out;
  - a building or grandparented structure that is rendered useless for the purpose of deriving income, and is demolished or abandoned for later demolition because of damage to this property as a result of the Kaikoura earthquakes;

NEW LEGISLATION

  - buildings or grandparented structures that are depreciated under the pool method and that are located in the earthquake-affected area covered by: the Canterbury Regional Council, the Hurunui District Council, the Kaikoura District Council or the Marlborough District Council areas;
  - buildings or grandparented structures that are depreciated under the pool method and that are located in the earthquake affected area covered by: the Wellington City Council, the Hutt City Council, or the Wellington Regional Council areas;
  - commercial fit-out depreciated under the pool method and that is located in the earthquake affected area covered by: the Canterbury Regional Council, the Hurunui District Council, the Kaikoura District Council or the Marlborough District Council areas;
  - commercial fit-out depreciated under the pool method and that is located in the earthquake-affected area covered by the Wellington City Council, the Hutt City Council or the Wellington Regional Council areas; or
  - property that is depreciated under the pool method, other than a building, grandparented structure or commercial fit-out; and
- in the absence of this section, the person would have an amount of depreciation recovery income under section EE 48 for the items of affected property;
- the person plans in the current year to acquire depreciable property (being replacement property) that meets the following requirements:
  - it is not intangible depreciable property;
  - it is acquired in or before the end of the person's 2019–20 income year; and
  - it is included in the same class of property if the old property was:
    - a building or a grandparented structure or commercial fit-out; or
    - a building or a grandparented structure or commercial fit-out depreciated under the pool method; and
    - it is located in the same earthquake-affected area as the affected depreciable property, unless the replacement item is plant and equipment; and
- the person provides written notice to the Commissioner of Inland Revenue by the later of 31 January 2018 or the date that the return of income is filed for the income year in which the amount of depreciation recovery income can be estimated; and
- the person provides the required annual notice of election to the Commissioner of Inland Revenue.

Provided the above conditions are met, an amount that would be depreciation recovery income, in the absence of this section, becomes an amount of suspended recovery income under section EZ 23BC(2). The amount of suspended recovery income is available to be allocated to replacement items. Any unallocated amount of suspended recovery income can be attributed to the earlier of:

- the end of the 2021–22 income year, where an amount of suspended recovery income remains unallocated under subsections (4) or (7); or
- the income year that a person decides not to acquire an amount of replacement property. The amount they decide not to spend is depreciation recovery income in that year; or
- the income year that the person goes into liquidation or bankruptcy.

Subsections (4), (5), and (6) allocate an amount of suspended recovery income for old items of depreciable property if the pool method was not used. Subsection (4)(a) reduces the amount of expenditure or costs for calculating an amount of depreciation loss for the replacement item for the purposes of section EE 16(4) or section EE 22. Subsection (4)(b) reduces the amount of unallocated recovery income available for future allocation. The amount of the reduction in subsections (4)(a) and (4)(b) is given by subsection (5).

Subsection (5) calculates the relevant proportion of remaining suspended recovery income that can be allocated to the replacement item. The amount of unallocated suspended recovery income (that is available for future allocation) is reduced by the amount that has been allocated to the replacement item in that income year. If, in an income year, the amount spent on replacement items is equal to or greater than the unallocated suspended recovery income, the amount of the reduction to additional replacement property is zero. The formula in subsection (5)(b) uses the lesser of the amount of unallocated recovery income remaining or the amount of expenditure on the replacement item. This also limits the total amount of suspended recovery income that can be allocated to replacement items.

Subsection (7) provides the reduction method for the cost or adjusted tax book value of replacement items when the old item was accounted for under the pool method. Subsection (7)(a) reduces the amount of expenditure incurred on replacement items and the reduction is applied depending upon the depreciation method applied to the replacement item. Subsection (7)(b) is intended to reduce the amount of unallocated recovery income (that is available for allocation in the future) by the amount allocated by subsection (7)(a).

Under section EZ 23BC(10) and (11) a person seeking to suspend an amount of depreciation recovery income under this section is required to file a notice annually with the Commissioner of Inland Revenue, providing the following details:

- describing the items of affected property; and
- indicating which of the following categories each item of old property is included: (i) a building or grandparented structure not previously accounted for under the pool method; (ii) commercial fit-out not previously accounted for under the pool method; (iii) depreciable property previously accounted for under the pool method; and (iv) depreciable property previously accounted for as plant and equipment; and
- each item of replacement property acquired in the current year and the category of old property the item is being linked to; and
- the amount of expenditure on the replacement item and the reduction of that expenditure because of the depreciation recovery income being linked to the replacement item; and
- giving the amount, for each category of old property, of the unallocated recovery income at the end of the current year.

The annual notice is not required for the income year after the person has filed their completed return for their 2019–20 income year.

Application date

This change applies from the beginning of the taxpayer's 2015–16 and later income years.

Damaged depreciable property that is uneconomic to repair – section EZ 78

New section EZ 78 provides for the deemed disposal and reacquisition of assets damaged in a Hurunui/Kaikoura earthquake and which are uneconomic to repair. The tax depreciation rules do not provide an appropriate outcome when an asset has been damaged in a Hurunui/Kaikoura earthquake and the insurer considers it to be uneconomic to repair (and requiring replacement), even though the asset may be physically repairable. This is because the current rules make a distinction between assets that are repairable and those that are irreparably damaged or rendered useless for earning income. Assets that are uneconomic to repair are generally included in the former category.

The consequence is that a taxpayer may face a significant unexpected tax liability when an insurance amount is received, as a result of the application of section EE 52. Section EE 52 treats as taxable any insurance proceeds in excess of an asset's adjusted tax value and expenditure on repairing the asset. This means that an amount greater than the depreciation deductions previously claimed for the asset may be treated as taxable. By contrast, for an asset that is irreparably damaged or rendered useless for earning income, the depreciation rules cap depreciation recovery income at the amount of previous depreciation deductions.

In addition, the depreciation "roll-over relief" rule in section EZ 23BC, has been made to align the treatment of assets that are uneconomic to repair with the existing treatment under the depreciation rules of assets that are irreparably damaged or rendered useless for earning income. This recognises that assets that are uneconomic to repair in the context of the Hurunui/Kaikoura earthquakes are, in substance, very similar to assets that are physically irreparable and therefore should receive similar treatment under the depreciation rules.

This objective is achieved through new section EZ 78, which treats assets that are uneconomic to repair as being disposed of for the amount of insurance received for the asset, on the date of the Hurunui/Kaikoura earthquake that caused the asset to be uneconomic to repair. This deemed disposal ensures that section EE 48 in the depreciation rules (which applies to irreparably damaged assets) also applies to assets that are uneconomic to repair.

The criteria for an asset to be subject to deemed disposal and reacquisition under section EZ 78 are:

- The depreciable asset is damaged by a Hurunui/Kaikoura earthquake, as that term is defined in section 4 of the Hurunui/Kaikoura Earthquake Recovery Act 2011.
- The owner of the asset is entitled to an amount of insurance or compensation for the damage to the item.
- The asset has been assessed by the insurer as uneconomic to repair.

- The damage has not caused the asset to be irreparably damaged or rendered useless for earning income in accordance with section EE 47(4).

Accordingly, when assets have sustained cumulative damage through multiple earthquakes and aftershocks, taxpayers can use the date of the earthquake that caused the asset to be damaged to the extent that it is uneconomic to repair as the relevant date of the deemed disposal and reacquisition under section EZ 78.

The asset is treated as being reacquired on the same date as the deemed disposal for nil consideration. This is to ensure that post-earthquake repairs are correctly capitalised (and not treated as deductible expenditure). Roll-over relief for income tax liabilities arising from the receipt of insurance for earthquake-damaged assets has been extended to assets that are subject to a deemed disposal and reacquisition under section EZ 78 by an amendment to section EZ 23BC.

Section EZ 78 overrides section EE 52, which means that for an asset meeting the criteria for section EZ 78 to apply, section EE 52 will not apply. The deemed disposal and reacquisition under section EZ 78 is not treated as a disposal or reacquisition for the purposes of the land provisions (sections CB 6 to 23).

Application date

This Hurunui/Kaikoura earthquakes-specific amendment applies for the 2015–16 and later income years.

Cap on depreciation recovery income – section EZ 79

New section EZ 79 limits depreciation recovery income calculated under section EE 52 to the amount of depreciation deductions previously taken, when insurance proceeds are received for a repairable damaged asset.

Section EE 52 provides that when insurance proceeds are received for damage to a repairable depreciable asset, the proceeds are taxable to the extent they exceed the cost of any repairs and the asset's adjusted tax value. As noted above, this means that the tax rules may end up taxing more than the amount of earlier depreciation deductions allowed for the asset. In the context of the Hurunui/Kaikoura earthquakes, this means that taxpayers may face significant unanticipated income tax liabilities in relation to damaged (but repairable) assets.

The cap on depreciation recovery income determined under section EE 52 is confined to depreciable assets damaged by a Hurunui/Kaikoura earthquake, the damage does not cause the asset to be irreparably damaged or rendered useless for earning income, and section EZ 78 does not apply to the asset.

Application date

This Hurunui/Kaikoura earthquakes-specific amendment applies for the 2015–16 and later income years.

Debt remission and associated amendments

Sections CD 5, CD 43, CD 44, CW 10, DB 13, DB 31, DV 18B, EW 46C, EW 49B and sections YA 1(69), (90) & (91) of the Income Tax Act 2007

Sections CD 4, CD 32, CD 43, DV 10C, EW 46B and section OB 1(2), (3) & (4) of the Income Tax Act 2004

The core amendment relies on an economic income analysis to determine whether a debt remission does not cause an increase in wealth and therefore should not be taxed, and focuses on situations when, if there was a debt capitalisation, there would be no real change in ownership (that is, no real increase in wealth). The amendments apply to debtors who are companies, look-through companies and partnerships. Other associated amendments apply to the bad debt rules and to guarantees.

Background

New Zealand tax law has long regarded debt remission as creating taxable income to the debtor, with the only exception being under the natural love and affection rules. While some commentators have argued that this had overreach in that it taxes gains that are not economic gains, there was a school of thought that if a debt was capitalised rather than remitted, there were no taxation outcomes. This made debt capitalisation quite common, especially inside wholly-owned groups.

Tax avoidance analysis completed in February 2015 (QB 15/01) about certain debt capitalisations that could be recharacterised as debt remissions changed this status quo.

The example in this QB focused on a natural person shareholder who owned all the relevant shares in a company and the capitalisation of debt owed by the company to the shareholder. It was found that this could be tax avoidance because the capitalisation is avoiding debt remission. This analysis can be extrapolated to wholly-owned group company situations and situations when debt is remitted pro rata to ownership in companies, look-through companies and partnerships.

After informal consultation officials released an issues paper in February 2015 that defined the problem and proposed a solution that means QB 15/01 no longer applies. While there was considerable discussion of the detail, the paper's problem definition and solution were generally accepted.

Throughout this process all parties have been aware of the risk that past transactions could be reconsidered and many submissions were received on this. The retrospective application date of these amendments has addressed this concern.

Key features

The core debt remission rule is new section EW 46C in the financial arrangement rules. This specifies who the proposal can apply to:

- wholly-owned group companies where the debtor is New Zealand-resident;
- wholly-owned group companies where all of the voting (or market value) interests in the debtor (that is, a CFC) are held by or through New Zealand-resident companies;
- debtors that are companies, partnerships or look-through companies where the debt is remitted by owners pro rata to ownership;
- specific rules where the creditor who remits the debt is connected with the owner (wholly-owned group companies and situations when the creditor could remit a debt owed by the owner under the natural love and affection rules).

The "New Zealand" limitations are to ensure there is no transfer of value that should be a dividend to a non-resident.

The remission (full or partial) deems the amount remitted to have been repaid so there is no connected base price adjustment income.

Supporting rules:

- limit the definition of "dividend" to remove debt remission that the core proposal applies to from being a dividend inside a New Zealand-resident wholly-owned group of companies;
- make changes to the available subscribed capital (ASC) rules;
- create cost base (where ASC is also created);
- limit the capital gains distribution rules;
- change the exempt dividend rules; and
- amend the bad debt deduction rules.

An associated set of rules concerning guarantees of loan is also part of the package.

Application dates

There is a range of application dates. These are discussed in the detailed analysis below.

Detailed analysis

In summary, the amendments that relate to the new core debt remission rule (section EW 46C) in the Income Tax Act 2007 are:

- section CD 5 to ensure that when the core debt remission rule applies the remission is not a dividend;
- section CD 43 to ensure that when a shareholder remits debt that is treated as a debt capitalisation and creates ASC;
- section CD 44 so that when there is an inter-corporate debt remission that does not create ASC, but that qualifies for relief under the core rule, the debtor's gain is not regarded as a capital gain;
- section CW 10, which provides an exception to the New Zealand resident wholly-owned group companies intra-corporate dividend exemption (ICDX) for debt remission, is repealed as it is no longer necessary;
- section DB 31 is amended to ensure that there is no bad debt for interest accrued when the debtor and the creditor are associated persons;
- section DV 18B is added to provide cost base when ASC is created; and
- section EW 46C is then amended to give a delayed application for the interest part of debt remission.

A number of similar amendments have been made to the Income Tax Act 2004 to ensure appropriate retrospective application.

In addition, new section EW 49B is inserted to deal with guarantees and associated persons, and section DB 13 has been consequentially amended.

The core rule

At a conceptual level, the core rule means that where a debt remission does not cause economic income and a corresponding increase in economic wealth (and does not amount to a dividend), the debt remission should have no taxation consequences. For example, a debt remission or a debt capitalisation within a New Zealand resident wholly-owned group of companies does not produce economic income (or an increase in net wealth) to the owner of the group. Another example is provided in QB 15/01 is when neither remission nor capitalisation of the debt advanced by the shareholder to the company causes economic income or net wealth of the owner to increase.

Section EW 46C contains the core mechanics of the new debt remission rule which provides relief from the Income Tax Act 2007's previous proposition that, natural love and affection excepted, debt remission increases the debtor's wealth and should be taxed. This analysis will consider the section's application separately to:

- wholly-owned group companies; and
- other ownership structures.

Application dates

Section 46C and its associated amendments apply for the 2008–09 and later income years. Similar amendments have been made to the Income Tax Act 2004 that apply for the 2006–07 and the 2007–08 income years. The only exception to this is that the Amendment Act amends section 46C from 1 July 2017 to ensure that from that date accrued but not paid interest is subject to the core debt remission rule.

Wholly-owned group companies

Section EW 46C(1)(a) applies to wholly-owned group companies when the debtor is New Zealand-resident. Conceptually this paragraph has limited relevance as paragraph (b) provides what is generally a wider rule, but practically it provides a simple rule for most wholly-owned group companies.

However, it is relevant when the debtor is the top tier New Zealand company and the creditor is part of the New Zealand-resident group of companies.

Section EW 46C(1)(b) is the more general rule for wholly-owned group companies. This paragraph deals with wholly-owned group companies where:

- the debtor is not the top tier New Zealand company (refer paragraph (a)); or
- all of the ownership interests (voting or market value as appropriate) in the debtor company are held by New Zealand members of the group before section YC 4 (the corporate look-through rule) is applied. Thus, this includes New Zealand-resident group members other than the top tier company and CFCs that are wholly-owned by the New Zealand-resident group companies.

The point about the residence of the debtor is to ensure that there is no debt remission where a non-resident shareholder benefits. The present dividend rules should continue to apply in this situation.

Note that the wholly-owned provisions do not extend to FIFs, where one is wholly-owned by the other, but they are not wholly owned by the New Zealand FIF owners. Consideration will be given to addressing this as a remedial in a future tax bill.

Subsections EW 46C(4) and (5) provide that where the debt, the debtor and the creditor are described in paragraphs EW 46C(1)(a) or (b), the amount forgiven is deemed to have been repaid on the date of the forgiveness.

Other ownership and debt structures

Paragraphs EW 46C(1)(c), (d) and (e) bring in debt owed to their owners by other companies, partnerships (including limited partnerships) and look-through companies respectively. However, there are further criteria before relief applies.

Subsections EW 46C(4) and (5) also provide that the amount forgiven is deemed to have been repaid if the "proportional debt ratio" for the amount forgiven equals the "proportional ownership ratio".

Subsection EW 46C(6) provides that:

- "proportional debt ratio" means, for a creditor and an amount of debt, the ratio of this debt to the total amount of debt forgiven;
- "proportional ownership ratio" means the ratio of the creditor's ownership interests in the debtor, ignoring "nominal shares"; and

- "nominal shares are shares held by the trustee of an employee share scheme, or employees or former employees (this includes shareholder-employees), of the debtor where these shares total no more than 3% of the ownership interests (voting or market value as appropriate) in the debtor.

Subsection EW 46C(2)(b) recognises the section EW 44 natural love and affection rules and imports their intention into these debt remission rules. This is because in some circumstances the anti-avoidance analysis in the QB may have extended to encompass such scenarios.

The paragraph provides that a group of natural persons who each can have natural love and affection for each other and who, in relation to the debtor, are either owners or are creditors are regarded as one person for the purposes of this core rule.

The paragraph then provides that a trust may join the group if:

- the trust was established mainly to benefit natural people for whom each natural person of the group has natural love and affection; and
- the net effect is that the trust is not remitting more debt than its share according to its ownership interests (this parallels the treatment of trusts in section EW 44).

Points to note

Paragraph EW 46C(2)(a) provides that the means of debt forgiveness is immaterial.

Subsection EW 46C(3) provides that when the creditor is non-resident and is a member of the same wholly-owned group of companies as the debtor, the section does not apply if the debt has been held by a person who is not a member of the wholly-owned group. This is to prevent "debt parking" when the creditor is not in the New Zealand tax base.

As discussed above, section EW 46C(4) and (5) provides that the amount forgiven is deemed to be paid and received. Once the financial arrangement rules have recognised the (interest) income or the (interest) expenditure will eventually either be paid and received or be deemed to have been paid and received. In particular, this could impact on loans associated with direct inbound investment.

Supporting amendments

There are a number of supporting amendments. Except for the bad debt amendments, these all apply for the 2008–09 and later income years.

Bad debts

The bad debt amendments apply from 1 July 2017.

There are two sets of amendments to the bad debts deduction section DB 31. The amendment that relates to debt remission is new paragraph DB 31(2)(bb). This paragraph denies a deduction for a bad debt for financial arrangement income if the debtor is associated to the creditor, except when the debtor is not in the New Zealand tax base.

This is to prevent the double deduction, one stream of income that often arises in the associated persons situation. The deductions being:

- the debtor's financial arrangement (interest) deduction; and
- the creditor's bad debt deduction.

The creditor has financial arrangement (interest) income.

When the debtor is not in the New Zealand tax base, the double deduction issue does not arise (and, equally, if the creditor is not in the New Zealand tax base the bad debt rule does not apply anyway).

When the core debt remission rule in section 46C could apply to the associated persons debt, this amendment merely removes the timing advantage, as, if that rule is applied, the debt, including interest, is deemed to be paid (and any bad debt taken is clearly recovered).

There is an associated amendment to section 46C which provides that from 1 July 2017 the debt expressly includes interest that is accrued and unpaid. Thus any bad debt write-off of interest accrued before 1 July 2017 is not automatically reversed by the application of the general provisions of section EW 46C to the debt.

ASC

The forgiveness of debt owed by a company by its direct or indirect shareholder(s) where, if the debt was instead capitalised, there would be no dilution of ownership, is economically similar to debt capitalisation. Further, under subsection CD 46(6)(c), debt capitalisations create ASC.

This raises the question of whether qualifying debt remission should also create ASC. Conceptually it should where the creditor has ownership interests in the debtor.

New sections CD 43(6B) to CD 43(6D) have been added to explicitly provide that in certain situations there is an uplift of ASC in the debtor.

Section CD 43(6B) points to situations where inbound debt (non-resident owner who is also the creditor) is deemed to have been repaid under the group company provisions of section EW 46C – that is paragraphs EW 46C(1)(a) or (b).

Section CD 43(6C) points to a section EW 46C(1)(c) debt remission (company debtor, but creditor not in the wholly-owned group) and provides that those companies receive ASC.

These two provisions point to section CD 43(6D) which provides that the ASC of the corporate debtor is increased by the amount that is remitted.

However, in the wholly-owned group situation (paragraph EW 46C(1)(a) or (b) remissions) if the parties want to create ASC by debt capitalisation or similar, they may, but any compulsory imposition of the creation of ASC in this situation seems unnecessary (and can be complex).

Accordingly the provision of ASC for debt remission is limited to situations outside the wholly-owned group debt remission – that is, situations when paragraph EW 46C(1)(a) or (b) does not apply. The one exception to excluding the wholly-owned group debt remission from creating ASC is where the debtor is directly owned by non-resident wholly-owned group companies and the debtor is also non-resident (and the New Zealand company has no ownership interests in the non-resident owner or the debtor). In this case the creation of ASC is simple and, because of the direct non-resident ownership, warranted.

Subsection CD 43(6D) provides that ASC is increased for the corporate debtor by the amount remitted. Where there are companies in the wholly-owned group between the debtor and the non-resident creditor their ASC is also increased pro rata to their ownership interests in the debtor.

Cost base

New section DZ 18B provides a cost base for the shareholders where the debtor receives an increase in ASC.

Capital gain amount

In a number of cases the application to section EW 46C to a remission of the debt of a company will not cause that company to have ASC. To limit the planning opportunities section CD 44 has been amended to ensure that any "capital gain amount" does not include a gain made by a debt remission that qualifies for section EW 46C relief.

What is a dividend – transfer of value

Section CD 5 provides that a dividend includes a loan remission where the shareholder is the debtor. Where new EW 46C applies to relieve debt remission income in a wholly-owned group situation, section CD 5 has been amended to ensure that this does not result in a dividend.

Inter-corporate dividend exemption (ICDX)

Section CW 10(4) provides that the ICDX does not apply if the dividend arises from a remission of debt. Given the changes in sections CD 5 and EW 46C this subsection is no longer needed and is repealed.

Associated amendments – guarantees of loans

These amendments apply from 1 July 2017.

Concerns about guarantees of debt where the guarantor and the debtor are associated persons have also been addressed. The particular concern is the suggestion that a guarantor can obtain a tax deduction for a payment under a guarantee of an associated person's debt. From an "economic group" such a deduction is inappropriate from a tax policy perspective.

The new section EW 49B has three core provisions:

- the associated person guarantor is denied a tax deduction for a guarantee payment because the payment is treated as not being consideration paid or payable by the guarantor (section EW 49B(4));
- for the debtor, the loan being guaranteed is deemed to be repaid to the extent of the guarantor's guarantee payment (section EW 49B(2)); and
- if the guarantor has recourse, a new interest-free loan is deemed to exist under which the guarantor has advanced a loan to the debtor equal to the guarantee payment to the creditor.

Where the guarantee payment extinguishes the debtor's original loan, the BPA will produce in the usual course of events income to the debtor of any difference between the loan balance the debtor owes the creditor immediately before the guarantee payment was made.

Subsequent treatment of the deemed loan

If the debtor liquidates, the BPA on the deemed loan has to be performed and this will trigger a BPA on the deemed loan. When the new debt remission rules apply this deemed loan will be treated by both the guarantor and the debtor as being repaid to the extent that the liquidation causes a shortfall and the debtor will not have any BPA income on this.

When the debtor is able to make repayments that exceed to amount of the deemed loan, these repayments are deductible to the debtor and are income to the guarantor. (Refer to sections EW 49B(4), CC 3(1) and DB 13(1).)

Loss grouping and imputation credits

Sections OB 19B, OB 46B, OB 71, OB 72, OB 72B, OB 83, OB 84, Table O1, Table O2 of the Income Tax Act 2007

Amendments allow companies that are commonly owned (at least 66 percent common voting interests) but not wholly owned (100 percent) to transfer imputation credits as part of loss grouping. Imputation credits can be transferred to the company that receives the benefit of the loss grouping (the profit company) and be sourced from either the company that provides the benefit of the loss grouping (the loss company) or another company in the group that will receive the benefit of a dividend paid by the profit company (the imputation source company).

Without this imputation credit transfer the profit company, due to the reduction in income tax it pays because of loss grouping, may not have sufficient imputation credits to pay an imputed dividend to its shareholders. If a company pays an unimputed dividend its shareholders will have to pay income tax on the dividend, which effectively claws back the benefit of the loss grouping.

Application date

The ability to transfer imputation credits applies to loss grouping for the 2017–18 and later income years.

Background

The Income Tax Act 2007 permits a loss company to elect to make the benefit of the loss available to a profit company in a commonly owned group. The loss company does this by offsetting some or all of the loss against the net income of the profit company. Alternatively a profit company can make a deductible subvention payment to the loss company. These are collectively referred to as loss grouping.

A profit company that has benefited from loss grouping will pay less income tax and therefore generate fewer imputation credits. If the profit company is wholly owned by its parent company, any dividends will not be taxable due to the inter-corporate dividend exemption. However, if the profit company is not wholly owned as part of a group that includes the loss company, the reduced level of imputation credits may mean the dividend cannot be fully imputed.

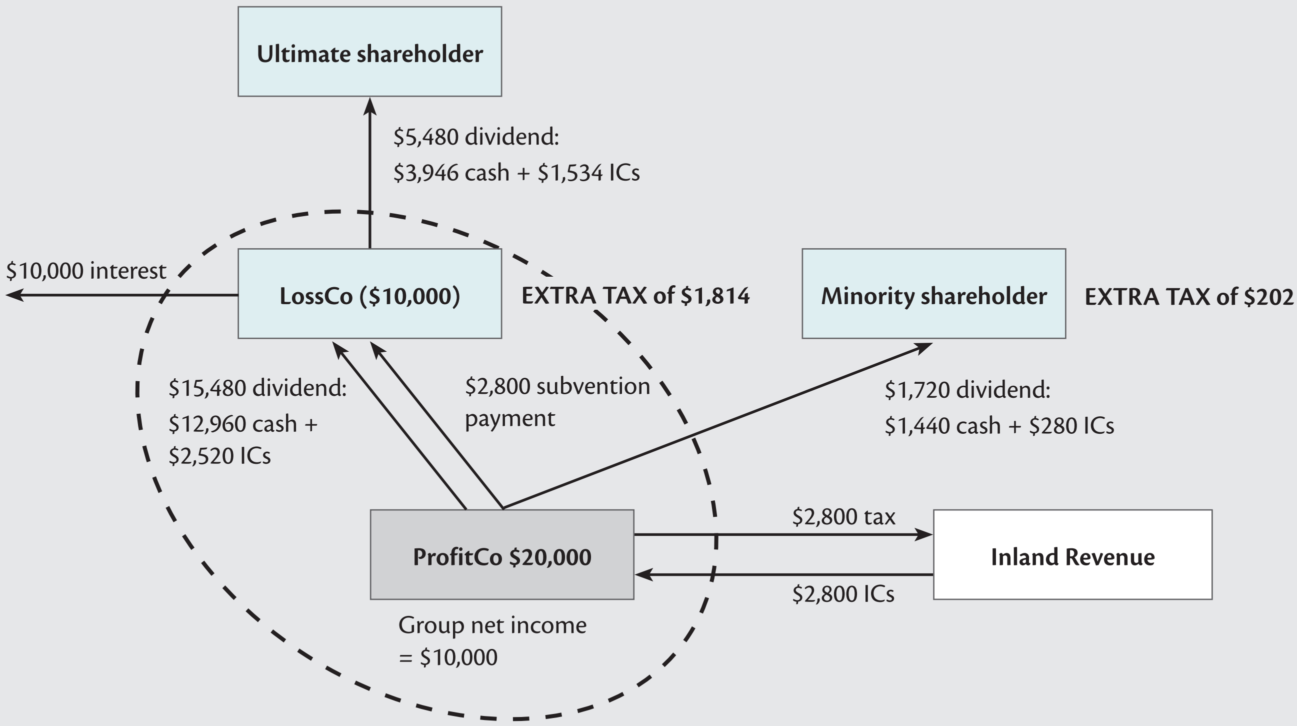
When a shareholder of the profit company receives a partially imputed dividend they will have to pay income tax to the extent the dividend is not fully imputed.[12] This income tax effectively claws back the benefit of the loss grouping and may leave the owners of the profit company worse off than if the loss grouping had not occurred.

[12] This will depend on the shareholder's marginal tax rate. Examples in this *Tax Information Bulletin* are simplified by assuming all shareholders have a 28% tax rate.

Example 1

LossCo has a 90 percent shareholding in ProfitCo (which makes it eligible to group losses).

- LossCo's $10,000 loss is transferred to ProfitCo via a combination of a $2,800 subvention payment and a loss offset election for the remaining $7,200 tax loss.
- ProfitCo has $10,000 of profit after the loss grouping so pays $2,800 tax. It therefore has $14,400 of cash[13] and $2,800 of imputation credits.
- ProfitCo pays 10 percent of its profits as a dividend to Minority shareholder. This is $1,440 cash and $280 of imputation credits. This dividend is not fully imputed so Minority shareholder has to pay extra tax of $202.
- ProfitCo pays 90 percent of its profits as a dividend to LossCo. This is $12,960 cash and $2,520 of imputation credits. This dividend is not fully imputed so LossCo has to pay extra tax of $1,814.
- LossCo pays its $10,000 interest bill and distributes its remaining $3,946[14] as a cash dividend with $1,534 of imputation credits attached.
- This can be shown in a diagram as:



As this issue does not arise within a wholly owned group, due to the inter-corporate dividend exemption, the previous tax settings provided an incentive for groups to be wholly owned rather than take on minority shareholders. The amendments remove this tax disadvantage against non-wholly owned groups.

Detailed analysis

The amendments allow imputation credits equal to the tax effect of loss grouping to be transferred to the profit company by another member of the group provided the eligibility criteria are met.

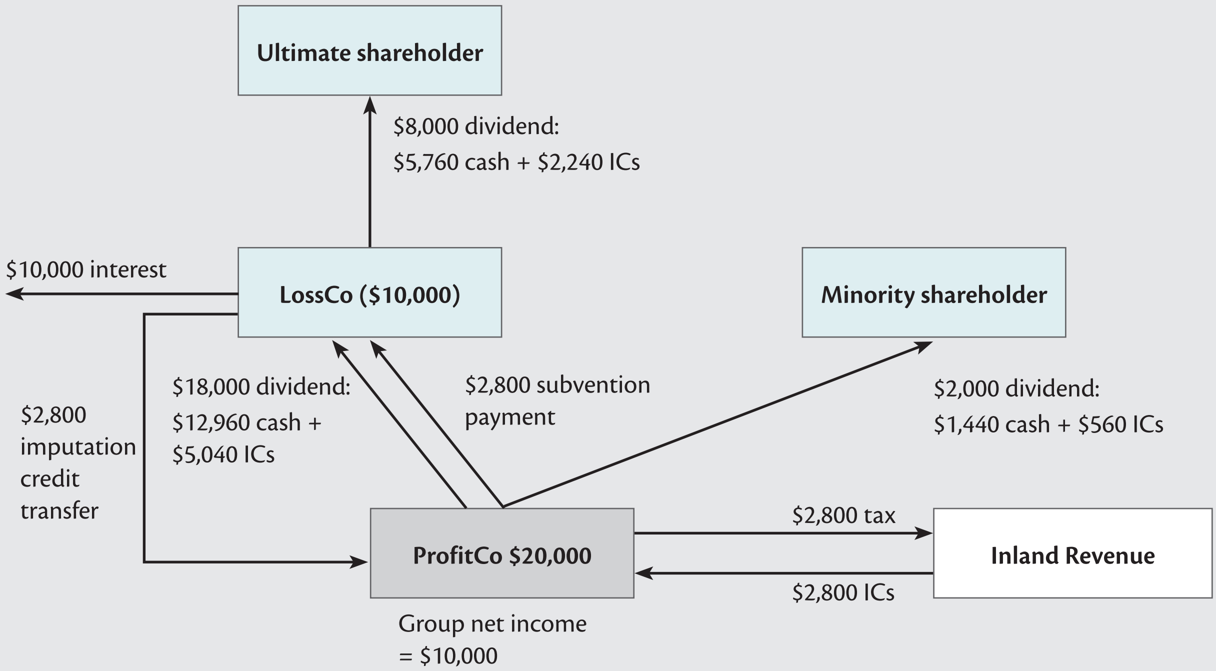
NEW LEGISLATION

[13] $20,000 less $2,800 subvention payment and $2,800 tax payment.

[14] $2,800 subvention payment plus $12,960 cash dividend less $10,000 interest payment less $1,814 tax payment.

Example 2

- As part of the $2,800 subvention payment and $7,200 loss offset, LossCo also transfers $2,800 of imputation credits.
- ProfitCo still has $10,000 of profit after the loss grouping so pays $2,800 tax. It therefore has $14,400 of cash and $5,600[15] of imputation credits which is the same as if no loss grouping had occurred.
- ProfitCo pays 10 percent of its profits as a dividend to Minority shareholder. This is $1,440 cash and $560 of imputation credits. As this dividend is fully imputed Minority shareholder has no extra tax to pay.
- ProfitCo pays 90 percent of its profits as a dividend to LossCo. This is $12,960 cash and $5,040 of imputation credits. At this dividend is fully imputed LossCo has no extra tax to pay.
- LossCo pays its $10,000 interest bill and distributes its remaining $5,760[16] as a cash dividend with $2,240 of imputation credits attached.
- This can be shown in a diagram as:



Amount of credits

The maximum amount of imputation credits that can be transferred as part of a loss grouping transaction is:

(amount of subvention payment +amount of loss offset election) × *the company tax rate*[17]

There is no restriction on a group of companies transferring less than the maximum amount.

Destination of credits

The company receiving the imputation credits is always the same company that received the benefit of the loss grouping (the profit company).

Source of credits

The company transferring the imputation credits can be one of the following companies, at the option of the group:

1. a company within the same commonly owned group that has transferred its loss to the profit company (the loss company); or
2. a company within the same commonly owned group that has an ownership interest of at least 66 percent in the profit company (the imputation source company).

[15] $2,800 from tax paid and $2,800 from the imputation credit transfer.

[16] $2,800 subvention payment plus $12,960 cash dividend less $10,000 interest payment.

[17] The company tax rate for the return period that included the loss grouping.

Eligibility for transfers

Companies are eligible to transfer imputation credits if all of the following criteria are met:

- the profit company, the loss company and the imputation source company (if applicable) are:
  - all part of the same commonly owned group; and
  - eligible to maintain an imputation credit account;
- the profit company is not part of the same wholly owned group with either the loss company or the imputation source company (if applicable); and
- the loss company has elected to undertake an imputation credit transfer.

Imputation credit transfer election

In order to transfer imputation credits the loss company must make an election to the Commissioner to transfer imputation credits. This election should be emailed to **ICA.transfers@ird.govt.nz** at the same time that the income tax return including the loss grouping is due.

The election must include the following information:

- the name and IRD number of the profit company;
- the name and IRD number of the loss company;
- the name and IRD number of the imputation source company (if applicable); and
- the amount of the loss offset and/or subvention payment.

Timing of imputation credit transfer

The imputation credit transfer is recorded by an entry in the imputation credit account of each company at the time the loss company pays a dividend to its shareholders, rather than when the loss grouping occurs. This is the time at which the issue of insufficient imputation credits arises and mitigates the risk that this mechanism could be used as a way of imputation credit shopping.

The legislation achieves this by requiring that the imputation credits transferred are attached to a dividend paid by the profit company.

If the amount of the imputation credits attached to the dividend is less than the loss offset and/or subvention payment in the election, the transfer is limited to the amount of the imputation credits attached to the dividend. Any remaining balance from the election continues to be available to be transferred if and when a subsequent dividend is paid.

Limit on imputation credit transfers

Notwithstanding the amount of an imputation credit transfer election, credits cannot be transferred if any of the following events occur:

1. the loss company, profit company and imputation source company (if applicable) cease to be part of a commonly owned group or become part of a wholly owned group;
2. the loss company, the profit company or the imputation source company (if applicable) breach the shareholder continuity requirements for memorandum accounts for the period beginning on the first day after the year that contains the loss grouping; or
3. four years have passed since the end of the income year of the profit company that benefited from the loss grouping.

Imputation credit shopping rules

The existing imputation credit shopping rules prevent separate groups structuring so that one group can benefit from the tax payments or imputation credits of the other group. These rules, which previously applied only to certain transactions involving wholly owned groups, have been extended to cover transactions involving companies that have transferred imputation credits.

Existing section OB 72B calculates a restricted refund amount that can only be refunded if the company satisfies the Commissioner that the imputation credit for the refund arises from tax paid, or an imputed dividend received, by the company or another company that was part of the same wholly owned group before the company joined the new group. For the purpose of applying this rule to imputation credit transfers the restricted refund amount is also refundable if the imputation credit arises from an imputation credit transfer from a company that was part of the same group before the company joined the new group.

Remission income, tax losses and insolvent individuals

Sections CG 2, CG 2B, FC 1, FC 2, FC 10, IA 3B and MB 14 of the Income Tax Act 2007
Section 42C of the Tax Administration Act 1994
Section 14B of the Student Loan Scheme Act 2011

The amendments cancel tax losses of an insolvent individual who is either:

- discharged from bankruptcy; or
- fully released from provable debts under Part 5 (not including subpart 1) of the Insolvency Act 2006 (for example, on discharge from the No Asset Procedure).

The amendments improve the alignment of the income tax system with:

- the "fresh-start" principle of insolvency law;
- current administrative practice; and
- the neutrality of the tax system in relation to investment decisions.

Remedial amendments to section MB 14 of the Income Tax Act 2007 and section 14B of the Student Loan Scheme Act 2011 ensure that earlier reforms to the treatment of tax losses of a person discharged from bankruptcy are consistent with the objectives of Working for Families and the Student Loan Scheme.

Background

The key objective of the fresh-start principle in insolvency law is to permit an insolvent person to resume economic activity free of the burden of debt. However, this statutory intervention in contract law requires the insolvent person to:

- surrender his or her assets for equitable distribution among creditors (subject to minimal retentions for family maintenance); but
- permits the retention of a minimal level of personal assets for the purposes of family or personal maintenance and for tools of trade. The Official Assignee is able to determine which assets may be retained.

However, a carried-forward tax loss can be a significant benefit (a tax asset) for a taxpayer because it can reduce tax that would be otherwise payable in the future. The policy of allowing tax losses to be carried forward without regard to insolvency was inconsistent with the key objective of the fresh-start principle in that it allows what may be a significant asset to be retained post-bankruptcy.

The ability of an individual taxpayer to carry forward tax losses may also have influenced investment decisions. Assuming all other things to be equal, where tax losses currently survive bankruptcy, the use of the sole trader business structure would likely be preferred over a company structure because tax losses of a company are extinguished on liquidation.

This non-neutral outcome also arises because the remission income rules that apply on discharge from bankruptcy do not apply to all forms of debt. For example, the remission income rules do not apply to a fixed-term loan (a financial arrangement) used to finance the purchase of trading assets but do apply to trade debt. Therefore, it is likely that a taxpayer would prefer to finance the business trading activity with a debt that would not be subject to the remission income rules (which would mean that carried-forward tax losses are not reduced on discharge from bankruptcy).

A horizontal equity concern was that the tax system previously allowed the future tax benefit of carried-forward tax losses (an asset) to be retained following discharge from bankruptcy. This meant that a discharged bankrupt with carried-forward tax losses had an advantage compared with a discharged bankrupt who did not have carried-forward tax losses. This was a non-neutral outcome in the context of the fresh-start principle.

Key features

Alignment of tax system with objectives of insolvency

The amendments align the tax system with the fresh-start principle of insolvency law by ensuring that the benefit of tax losses cannot be carried forward after discharge from bankruptcy if a person is relieved fully of debt obligations to which insolvency law applies. However, if on discharge, no debts are cancelled, tax losses of the discharged bankrupt would still be able to be carried forward after that discharge.

Neutrality of the tax system for investment decisions

Before these amendments, the tax system potentially resulted in a non-neutral tax treatment for tax losses of a discharged bankrupt. This is because remission income arises for some types of business debt finance (for example, trade debts) but not for other forms of business finance (for example, capital, financial arrangement debt or a bank overdraft).

These different tax effects may lead to taxpayers preferring one form of business finance over another. The amendments result in this potential preference being removed from the tax system. The amendments also ensure that all taxpayers who are discharged from bankruptcy are treated alike in that the benefit of tax losses is not generally available after discharge from bankruptcy.

Obligation to file return of income for the bankrupt estate

In addition, there was some uncertainty about who was required to file a return of income for the bankrupt during the period of bankruptcy (often referred to as the bankrupt estate). The amendments clarify that a person in bankruptcy is required to file a return of income during bankruptcy, unless they are a non-filing taxpayer.

Remedial matters

Potential adverse outcomes from recent amendments to the remission income rules in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 are addressed by the retrospective remedial amendments to section MB 14 of the Income Tax Act 2007 and section 14B of the Student Loan Scheme Act 2011.

Application dates

The amendments to the Income Tax Act 2007 (other than section MB 14) and the Tax Administration Act 1994 apply to a person who is fully released from debt obligations on or after 30 March 2017, either:

- on discharge from bankruptcy; or
- under any procedure in Part 4 of the Insolvency Act 2006.

The amendments to the Income Tax Act 2007 relating to unallocated deductions apply to a person adjudged bankrupt after 30 March 2017.

The amendments to section MB 14 of the Income Tax Act 2007 and section 14B of the Student Loan Scheme Act 2011 apply to a person who is discharged from bankruptcy after 1 April 2014.

Detailed analysis

Section IA 3B: Tax losses not able to be carried forward

Section IA 3B applies to a person who has a tax loss for a tax year in which that person is released from all provable debts (other than those preserved by the Insolvency Act 2006) either:

- on discharge from bankruptcy; or
- under a proposal to creditors, a summary instalment order or the no asset procedure (all described in Part 5 of the Insolvency Act 2006).

Before being released from these debts, if the Commissioner has written off outstanding tax of the insolvent, the Commissioner is required reduce tax losses under section 177C(5) of the Tax Administration Act.

An insolvent's tax loss at the time of bankruptcy may consist of any number of tax loss components, including a loss balance from the prior year, and a net loss the insolvent has for the part-year period prior to the date of bankruptcy.

After being released from these debts, the insolvent's tax loss:

- may be used by the insolvent only to pay a shortfall penalty that has been incurred before the date those debts are released;
- may not otherwise be carried forward in a loss balance to the part-year period following the date the debts are released; and
- may not otherwise be carried forward in a loss balance to any tax year starting after the date the debts are released.

Sections FC 1, FC 2 and FC 10: Tax treatment of property vesting in the Official Assignee on being adjudged bankrupt

When a person is adjudged bankrupt, all property belonging to or vested in the bankrupt is vested in the Official Assignee under section 101 of the Insolvency Act 2006. This vesting is subject to a common law right of the bankrupt to retain sufficient property for personal or family maintenance reasons, or as tools of trade.

Section FC 10 applies to a person adjudged bankrupt and ensures that property vesting in the Official Assignee is valued correctly in the calculation of the bankrupt person's taxable income for the part-year period up to the date of adjudication.

Sections FC 1 and FC 2 have been consequentially amended to address the relationship of those provisions with section FC 10.

Revenue account property subject to section EA 1

Section FC 10(2) provides that revenue account property that is subject to section EA 1 (trading stock, livestock and excepted financial arrangements) is treated as a disposal and acquisition at market value for income tax purposes. This ensures that:

- for the bankrupt person, the property is disposed of at market value at the end of the pre-bankruptcy period; and
- the Official Assignee is treated as acquiring that property at that market value.

Revenue account property subject to section EA 2

Section FC 10(3) applies to the cost of revenue account property for which the deduction is allocated to the year in which the property is disposed of. Section FC 10(3) prevents the deduction from being allocated to the part-year period when the property is vested in the Official Assignee.

It is inconsistent with the objectives of insolvency law for a person to benefit by way of a deduction being allowed on the disposal of property by way of vesting in the Official Assignee.

Depreciable property

Section FC 10(4) treats the vesting of an item of depreciable property in the Official Assignee as a disposal for consideration equal to the adjusted tax value as at the transfer date. This ensures that the bankrupt does not have either a depreciation loss or depreciation recovery income on the vesting of that property.

It is inconsistent with the objectives of insolvency law for an insolvent person to either benefit from a deduction being allowed or being taxed on a gain on the disposal of property by way of vesting in the Official Assignee.

Other unallocated deductions

A number of provisions in the Income Tax Act 2007 allocate deductions for expenditure on property over a period of time under spreading rules. Section FC 10(5) and (6) provide that the vesting of this property in the Official Assignee does not result in any unallocated deduction being timed to the year in which the property vests.

It is inconsistent with the objectives of insolvency law for a person to benefit from a deduction being allowed on the disposal of property by way of vesting in the Official Assignee.

Example: Unallocated deductions

Gary carries on a business of horticulture as a sole trader. During the 2012–13 tax year, Gary plants non-listed horticultural plants, at a cost of $400,000. These plants are first used for the benefit of the horticulture business in the 2013–14 tax year.

Under section DO 4, this deduction is spread using a diminishing value methodology, at the rate of 10% DV.

On 30 June 2017, Gary is declared bankrupt. At the end of the 2016-17 tax year, Gary's unallocated deduction for these plants is $262,000. These plants are vested in the Official Assignee, along with the business and all of its assets, at 30 June 2017.

As the vesting of the plants in the Official Assignee means the plants are no longer used by Gary in deriving income, section DO 4(6) would normally apply to time the unallocated deduction ($262,000 at the end of the 2016–17 tax year) to the 2017–18 tax year.

However, section FC 10(5) and (6) override the effect of section DO 4(6) and prevent it timing the unallocated deduction of $262,000 to the 2017–18 tax year.

Section 42C of the Tax Administration Act 1994: Clarification of return filing obligations

Under section 102 of the Insolvency Act 2006, income earned (generally income derived from personal exertion) by a bankrupt during the period of bankruptcy is vested automatically in the Official Assignee as it is earned. However, this is subject to the common law right to retain sufficient funds from that income for the purposes of personal or family maintenance.

For income tax purposes, personal exertion income is derived by the person who has earned it, despite assignment to, or vesting of that income in, another person. This principle arises from the decision of the Judicial Committee of the Privy Council in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1993 15 NZTC 10,106).

There was some uncertainty about who was required to file a return of income for the bankrupt during the period of bankruptcy (often referred to as the bankrupt estate). The amendments clarify that a person in bankruptcy is required to file a return of income during bankruptcy, unless they are a non-filing taxpayer.

As noted earlier in this item, a person who is adjudged bankrupt may carry their unused tax loss into bankruptcy, subject to the power of the Commissioner to write that tax loss down under section 177C(5). The bankrupt person may use that tax loss during the period of bankruptcy:

- to reduce tax payable on personal exertion income or any other income derived during bankruptcy; or
- to satisfy a short payment penalty that was incurred prior to discharge from bankruptcy.

To ensure that an unused tax loss is carried forward by Inland Revenue into the part-year period after the date of adjudication or from one tax year to the next during the period of bankruptcy, the bankrupt person will need to ensure that those unused losses are recorded correctly in their annual return of income.

Sections CG 2 and CG 2B: Necessary consequential amendments

These amendments improve the alignment of the remission income rules with the objective of the fresh-start principle of insolvency law.

New section CG 2 (4)(ab) provides that remission income does not arise for debts cancelled by the operation of the Insolvency Act on either:

- discharge from bankruptcy; or
- under any proposal to creditors, a summary instalment order or the no asset procedure (all described in Part 5 of the Insolvency Act 2006).

Section CG 2B has been repealed. The purpose of section CB 2B was to "claw back" tax losses if liabilities relating to past deductible expenditure were cancelled on discharge from bankruptcy. From 30 March 2017, the loss balance of a person discharged from bankruptcy is not able to be carried forward into any part-year period or tax year following that discharge.

Section MB 14 of the Income Tax Act 2007; section 14B of the Student Loan Scheme Act 2011

The meaning of "income" in Working for Families and the Student Loan Scheme has been amended to exclude any amount of remission income arising under section CG 2B from 1 April 2014 until its repeal on 30 March 2017.

As the purpose of section CG 2B was to claw back tax losses, its effect was neutral for income tax purposes but was included in income under Working for Families and Student Loan Scheme purposes. This could have reduced Working for Family entitlements, or resulted in higher student loan repayment levels. That was not intended. The amendment is retrospective to ensure that the Working for Families and Student Loan Scheme legislation work as intended.

Aircraft overhaul expenses: deductibility and timing

Sections CG 9, CZ 34, DW 5, DW 6, DZ 22, DZ 23, EA 2(1)(fc), EA 3(4B), EE 7(f), EE 45(12), EE 47(11), EE 57(3)(d)(ii), EE 58(2), EE 60(2)(e), EJ 24, EJ 25, EJ 26, EJ 27, EZ 23BA, FA 9(5), FA 10(7B), FA 11(8) and YA 1 "aircraft engine", "aircraft engine overhaul", "scheduled overhaul period" and "unpriced aircraft engine"

The amendments provide new timing rules that spread deductions for aircraft engine overhaul expenditure over the period between aircraft engine overhauls.

The timing rules apply to aircraft operators who operate aircraft powered by an engine or engines. Limiting the application of the rules in this way ensures that the rules do not apply to hot air balloon operators nor glider operators.

The amendments also:

- allow a transitional deduction to align the timing of deductions for the cost of an aircraft engine owned at the beginning of the 2017–18 income year with the new timing rules; and
- contain transitional rules applying deductions previously allowed under an administrative policy relating to provisions for aircraft overhaul expenditure.

Background

The amendments arise from a review of the timing of deductions for aircraft overhaul expenditure, following the withdrawal of a long-standing technical ruling by the Commissioner on the timing of deductions for this type of expenditure.

Under that withdrawn technical ruling, aircraft operators were permitted to quantify their deductions for aircraft overhaul expenses from provisions for future overhaul expenses (a spreading method).

The technical ruling was withdrawn because the Commissioner considers:

- the ruling was inconsistent with case law arising since that ruling was issued; and
- provisions for future overhaul expenses that have not been incurred do not satisfy the legal test of deductibility.

Key features

The amendments apply to all aircraft operators who use aircraft powered by engines. (For example, the amendments do not apply to hot air balloon operators.)

The new rules spread deductions for aircraft engine overhaul expenses over the period between overhauls, based on use of the aircraft. In this *Tax Information Bulletin* item these rules are referred to as the spreading rules.

Aircraft operators having just one aircraft may elect to opt out of these spreading rules and instead apply the general deductibility and timing rules for timing overhaul deductions. This election is not available for an operator that, together with associated persons, owns more than one aircraft.

These main features of the spreading rules are to:

- determine the deductibility and timing of aircraft engine overhaul expenses;
- determine the deductibility and timing of payments made to a lessor under engine maintenance and return obligations for a leased aircraft;
- apply the spreading rules to part of the acquisition cost of an aircraft engine (the engine overhaul component);
- the general deductibility and timing rules (for example, section EA 3) continue to apply to expenditure incurred on components and parts of an engine which are overhauled or replaced other than during the scheduled engine overhaul; and
- when an aircraft (or engine) is disposed of, engine overhaul deductions will be recovered in a manner consistent with the application of the depreciation recovery rules.

In addition, transitional rules:

- allow a catch-up deduction for the overhaul component of an aircraft engine owned by an aircraft operator at the beginning of the 2017–18 income year; and
- offset the balance (at the beginning of the 2017–18 income year) of accounting provisions for future overhaul expenses, against the cost of future overhauls.

IFRS taxpayers may, with the agreement of the Commissioner, apply IFRS accounting methods to determine the timing of aircraft overhaul expenses. However this applies only to:

- a taxpayer that is a resident of New Zealand; and
- a non-resident taxpayer in relation to their aircraft registered with the Civil Aviation Authority in New Zealand.

Application date

The amendments apply to expenditure incurred on aircraft engine overhauls and to acquisitions of aircraft and aircraft engines from the beginning of the 2017–18 income year and in all subsequent income years.

Detailed analysis

The amendments provide consistency with Civil Aviation Authority requirements

The spreading rules are based on and are consistent with the Civil Aviation Authority's (CAA) requirements for tracking when an engine overhaul must occur. The tax accounting for the costs of these overhauls will generally be consistent with the physical overhaul requirements mandated by the CAA. For example, the cost of overhauling or replacing the main transmission of a helicopter is subject to the spreading rules.

Under CAA rules for managing safety risks, an aircraft is not permitted to be in service unless it has a current airworthiness certificate. It is illegal to operate an aircraft without it having a current certificate of airworthiness.

To retain airworthiness status for an aircraft, a commercial aircraft operator must undertake a range of scheduled maintenance activities from time to time, based on time in service. Scheduled maintenance activities are set out in either:

- the manufacturer's maintenance programme; or
- CAA variations from the manufacturer's maintenance programme for the aircraft, and its various sub-components, including aircraft engines, propellers, rotors, appliances, emergency equipment and parts.

The scheduled maintenance programme consists of:

- replacement of components or parts after a stated period of time in service (airworthiness limitations, sometimes known as limited-life parts);
- hard-time maintenance when the aircraft or aircraft component is withdrawn from services and overhauled or replaced in its entirety (for example, a spare engine or spare landing gear); and
- on-aircraft inspection.

The overhaul of aircraft engines and aircraft engine components are an essential part of the total maintenance programme for an aircraft. However, an overhaul of an engine may also be required on an unscheduled basis – for example, as a consequence of damage caused by bird strike. The new rules also take into account that an operator having a fleet of aircraft may schedule maintenance activities at an earlier time than is mandated in the programme to accommodate their own operational practices.

Key definitions

The spreading rules are based on the definitions in section YA 1 of "aircraft engine" and "aircraft engine overhaul", and "scheduled overhaul period".

Aircraft engine

An aircraft engine is defined as those systems that give:

- propulsion for a fixed-wing aircraft; and
- lift and propulsion for a helicopter, including those systems that provide a counter-foil to the rotational effect of the main rotor and also the safety system that allows the helicopter to be landed safely if the engine fails.

However, the definition of "aircraft engine" does not include:

- propellers of a fixed wing aircraft; or
- rotor blades of a helicopter.

Aircraft engine overhaul

This is defined as a process of removing (if necessary), dismantling, testing, replacing or restoring elemental parts of the engine to performance specifications, and testing of performance, as mandated by the maintenance requirements for each aircraft.

For a helicopter, the overhaul process extends to all the lift and propulsion systems, including those that provide a counter-foil to the rotational effect of the main rotor and also the safety system that allows the helicopter to be landed safely if the engine fails.

Scheduled overhaul period

This is defined as the period between scheduled overhauls for an aircraft engine, as mandated by the maintenance programme for the aircraft. It is the maximum permitted interval for which the aircraft engine may be operated before the aircraft operator must carry out an aircraft engine overhaul. The maximum interval may vary depending on the measure used.

Example 1: Choosing the most appropriate scheduled overhaul period for the spreading rules

Company A owns a helicopter. Its main transmission is replaced in the first month of the 2017–18 income year at a cost of $135,000. The maximum permitted interval before the next scheduled aircraft overhaul is based on the earlier of flying hours or elapsed calendar time. The spreading rules permit the more appropriate of these two measurement bases to be used to determine the timing of deductions for an income year. It is accepted that the basis for the timing rule may vary between income years depending on usage.

The next scheduled overhaul for the main transmission is due after either 4,500 flying hours or 12 years, which implies an average of 375 hours/year.

In the 2017–18 income year, the helicopter has 460 flying hours after the overhaul, which exceeds average use. The owner therefore chooses flying time as the appropriate measure of use. The allowable deduction of $135,000 is allocated as follows:

2017–18 income year: $135,000 × 460/4,500 = $13,800

In the 2018–19 income year, the helicopter is relocated to Antarctica where the hours in use during the year reduce significantly to 150. For the 2018–19 year, the most appropriate measure of use is calendar time. The allowable deduction for the 2018–19 year is then:

2018–19 income year: $135,000 × 2 ÷ 12 = $22,500

Less allocated to 2017–18 year = $13,800

Net deduction available in 2018–19 year = $8,700.

Allowable deduction for aircraft engine overhaul expenses incurred

Section DW 5(2) allows a deduction for expenditure incurred for an engine overhaul after the beginning of the 2017-18 income year. However, this is subject to the proviso that the overhaul does not result in a significant increase in performance.

Generally, improvements in technology of engine components and parts will not be considered as giving rise to a significant increase in performance, even if the improvements in technology extend the scheduled overhaul period.

Alignment of tax rules with Civil Aviation regulation

Under Civil Aviation regulations, an aircraft operator is required to keep track of the time between overhaul or life information for each part and component installed in an aircraft engine. The operator is also required to keep track of that same information as a component moves to, and from, installation and inventory.

A common practice for helicopter operators is to swap parts or components of an engine in and out of an aircraft (to and from spare parts inventory) for operational reasons, to maximise time-in-service of the aircraft.

If the entire system is replaced, it is treated as an overhaul for the purpose of the spreading rules. The deductions relating to these parts or components relating to the aircraft engine will be allocated under the new spreading rule in section EJ 24 (or section EJ 25 for IFRS taxpayers).

For individual parts or components swapped in and out of an aircraft (to and from spare parts inventory), the allocation of the deduction to an income year for these items continues to be subject to the unexpired expenditure rule (a spreading rule) in section EA 3. An aircraft operator may be excused from applying this unexpired expenditure rule under Determination E12 (Persons excused from complying with section EA 3 of the Income Tax Act 2007).

Allocation of deduction (timing) for overhaul expenses

Under section EJ 24, the spreading rule allocates the deduction allowed under section DW 5(2) for an aircraft engine overhaul that occurs in the 2017–18 income year or a later income year. The spreading rule allocates the deduction to the periods following the overhaul using the most appropriate use measure, as determined for each year. The appropriate measurement basis may, therefore change, depending on the aircraft and the nature of the use measure.

Relevant use measures for the time-in-service basis for allocating the deductions are to be determined from the approved maintenance programme for the aircraft. For example, in many cases the relevant use measure will based on the scheduled time between overhauls, flying hours, landing cycles or heat emissions. The use measure must also take into account any modifications to the approved maintenance programme under airworthiness directives issued by the Civil Aviation Authority.

The following example illustrates how the spreading rule applies to the allowable deduction for an overhaul of an engine (or, in the example, the master transmission of a helicopter that is overhauled).

Example 2: Applying the spreading rule as an annual adjustment to the tax calculation

Company A owns a Bell Jetranger helicopter. Its master transmission has been overhauled for a cost of $135,000 in the first month of the 2017–18 income year and is returned to service in the second month of the same year. Its next scheduled overhaul is due after 4,500 flying hours. The helicopter on average is in use for 500 hours each year. The helicopter has 460 flying hours in the 2017–18 income year following the overhaul. The allowable deduction is $135,000 and is allocated as follows:

2017–18 income year: $\$135{,}000 \times \frac{460}{4500} = \$13{,}800$

2018–19 income year: $\$135{,}000 \times \frac{500}{4500} = \$15{,}000$ (assuming 500 flying hours)

In addition, if an out-of-cycle overhaul occurs early for operational reasons or damage (for example, bird strike damage), section EJ 24(3) ensures that any unallocated amount of the deduction for an aircraft engine overhaul is allocated to the year in which the overhaul occurs.

If a leased aircraft is returned early, section EJ 24(4) ensures that any unallocated amount of a deduction for an aircraft engine overhaul is allocated to the year in which the aircraft is returned to the lessor.

Annual adjustment in calculating taxable income

Some aircraft operators account for their overhaul expenses on an "as incurred" basis for financial reporting purposes. An annual adjustment to give effect to the spreading rule is necessary to ensure that the self-assessment of the operator's income tax liability for a tax year correctly applies the spreading rule for aircraft engine overhaul expenses.

Example 3 illustrates how an annual adjustment to financial accounting results takes into account the spreading rule for aircraft engine overhaul deductions of a taxpayer who, for financial reporting purposes, accounts for the costs of an aircraft engine overhaul on an as incurred basis.

Example 3: Annual adjustment on a part/component basis

Company F overhauls one engine on a twin engine helicopter in April 2017 at a total cost of $403,500. The company's income year ends on 31 March 2018. As the components and parts within the engine have differing flying hour (FH) requirements, a breakdown of the cost of the overhaul referable to each component/part is appropriate. These components/parts may be swapped out of the helicopter and replaced by another part/component due to ongoing normal maintenance requirements. For the example, all components/parts are assumed to remain installed on the helicopter during the 2017-18 income year.

Company F uses the following information at the end of the company's income year (31 March 2018) to calculate the deduction allocated to the 2017–18 income year for the calculation of taxable income, based on 400 flying hours during the year.

Description	Max TBO (flying hours)	Date of acquisition	FH remaining at 31 March 2018	FH 2017-18 income year	Cost of overhaul by component/ part	Allocated deduction (FH 2017-18 year ÷ max TBO × Cost)
					$	$
Total cost of engine overhaul					*403,500*[18]	
Core engine unit	1,800	30//4/2017	1,400	400	115,000	25,555
Axial rotor	15,000	30//4/2017	14,600	400	18,000	480
Impeller	15,000	30//4/2017	14,600	400	40,000	1,067
Compressor shaft	15,000	30//4/2017	14,600	400	2,500	67
GP rotor assembly	3,,600	30//4/2017	3,200	400	124,000	13,778
Fuel manifold	1700	30//4/2017	1,300	400	6,000	1,412
Power turbine rotor	5,400	30//4/2017	5,000	400	36,000	2,667
Power turbine governor	2,400	30//4/2017	2,000	400	15,000	2,500
Fuel pump	2,400	30//4/2017	2,000	400	10,000	1,667
Fuel control unit	2,400	30//4/2017	2,000	400	13,000	2,167
Flow fence actuator	2,400	30//4/2017	2,000	400	14.000	2,333
T1 Sensor	2,400	30//4/2017	2,000	400	10,000	1,667
Amount of deduction for engine overhaul allocated to 2017–18 income year						**$55,360**

Continuous accounting for parts and components used in financial reporting

Helicopter operators generally follow an operational practice of swapping engine parts and engine components in and out of aircraft (to, and from spare parts inventory), mainly to maximise time-in-service across the operator's fleet.

In some cases, an accounting practice adopted aligns the cost flow for these components and parts with the physical flow of the parts. One accounting method that reflects this practice is the standard costing method, under which each part or component is assigned a standard cost based on the maximum life of the component and the cost of the part or component.

This accounting approach to tracking costs and reporting the costs at the end of a financial year is consistent with the spreading rule in section EJ 24. Example 4 illustrates the use of standard costs for financial accounting purposes that are consistent with the spreading rule.

[18] Note that the actual cost of the overhaul during the 2017–18 income year would be reversed out in the tax calculation for that year and the amount of $55,360 would be included as a tax deductible expense for that year in the tax calculation.

Example 4: Tracking costs of parts and components using a standard cost basis

Company C overhauls one engine on a twin engine helicopter in April 2017 at a total cost of $410,000. The company's income year ends on 31 March 2018.

Company C uses a standard costing approach for financial reporting purposes, and uses the following information to determine the overhaul expense recognised in the financial reports of the company for its 31 March 2018 year. As the standard cost approach is consistent with the spreading method, the expense recorded in the financial reports represents an appropriate allocation of the deduction on a year-by-year basis. Therefore, Company C does not need to make any further adjustment from its financial reports for the spreading rule in relation to this particular overhaul.

Description	Max TBO (flying hours)	Date of acquisition	Cost of overhaul by component/ part	Standard cost per hour	FH 2017–18 income year	Overhaul expense (FH in year × standard cost)
			$	$		$
Total cost of engine overhaul			*410,000*			
Core engine unit	1,800	30/4/2017	115,000	63.89	400	25,556
Axial rotor	15,000	30/4/2017	18,000	1.20	400	480
Impeller	15,000	30/4/2017	40,000	2.67	400	1,068
Compressor shaft	15,000	30/4/2017	3,000	0.20	400	80
GP rotor assembly	3,600	30/4/2017	124,000	34.44	400	13,776
Fuel manifold	1,700	30/4/2017	7,000	4.12	400	1,648
Power turbine rotor	5,400	30/4/2017	37,000	6.85	400	2,740
Power turbine governor	2,400	30/4/2017	15,000	6.25	400	2,500
Fuel pump	2,400	30/4/2017	11,000	4.58	400	1,832
Fuel control unit	2,400	30/4/2017	14,000	5.83	400	2,332
Flow fence actuator	2,400	30/4/2017	15.000	6.25	400	2,500
T1 Sensor	2,400	30/4/2017	11,000	4.58	400	1,832
Amount of deduction for engine overhaul allocated to 2017–18 income year						**$56,344**

Quantifying the allowable deduction for aircraft overhaul component of an engine

Section DW 5(3) and (4) apply when an engine is acquired on a stand-alone basis, whether:

- the engine's cost is identified as a separate item when acquiring an aircraft, including an engine or engines; or
- the engine is acquired as a spare engine.

The amount of this deduction is determined from the estimated cost of an overhaul of that engine as at the date of acquisition of the engine. However, if the estimated cost of that overhaul exceeds the actual cost for the engine, section DW 5(c) limits the deduction to the actual cost of the engine.

New engine or newly overhauled engine

For a new engine or newly overhauled engine, the deduction under section DW 5(4)(a) is equal to the estimated cost of an overhaul of the engine determined at the time of acquisition. The residual amount is added to the base value (depreciable value of the aircraft as a whole). The apportionment between the deduction under section DW 5(4)a) and the base value of the aircraft is illustrated in Example 5.

Example 5: Application of section DW 5(4)(a) (engine cost identified)

Aircraft acquisition cost of $1.4m, engine cost separately identified as $460,000.

Estimated cost of an overhaul at acquisition is $450,000.

The estimated cost of an overhaul is less than the engine cost separately identified at acquisition. The allowable deduction is $450,000 but this is not fully deductible in the year the expenditure is incurred. The spreading rule in section EJ 24 requires this deduction to be allocated to income years based on an appropriate measure of use (for example, flying hours).

The base value of the aircraft for depreciation purposes is: $1,400,000 – $450,000 = $950,000

Used aircraft engines

For the acquisition of a used aircraft engine, the deduction for the overhaul component under section DW 5(4)(b) is equal to the estimated cost of an overhaul, reduced by an amount that takes into account the maintenance condition of the engine at acquisition. The adjustment is determined by the amount of time that is still to run before the engine is due for its next overhaul.

The aircraft operator is required to apportion the estimated cost of the overhaul amount between the expired and the unexpired portion of that estimate (based on relevant use measures). The expired portion is included in the cost base of the aircraft under the depreciation rules (as part of the base value) and the unexpired portion is the allowable deduction. This apportionment is illustrated in Example 6.

Example 6: Application of section DW 5(4)(b) (engine cost identified)

Aircraft acquisition cost of $1.4m; engine cost separately identified as $460,000.

Estimated cost of an overhaul at acquisition is $450,000.

The time between engine overhauls is 3,000 hours and the unexpired time in the overhaul period at acquisition is 2,800 hours.

The adjustment to the estimated cost of the overhaul required under section DW 5(4)(b) is as follows:

450,000 × 2,800 ÷ 3,000 = $420,000

The result of the calculation ($420,000) is less than the engine cost identified at acquisition.

The allowable deduction under section DW 5(4)(b) is $420,000, but this is not fully deductible in the year the expenditure is incurred. The spreading rule in section EJ 24 requires this deduction to be allocated to income years based on an appropriate measure of use (for example, flying hours).

The base value of the aircraft for depreciation purposes is – $1,400,000 – $420,000 = $980,000

Section DW 5(4)(c) applies if the acquisition cost identified for an engine is lower than the value of the deduction under either of sections DW 5(4)(a) or (b). In this case the deduction for the engine overhaul component is the cost for the engine.

Engine acquired with aircraft without identifying cost for the engine

Section DW 5(5) and (6) applies when an aircraft is acquired with its engine or engines, and the cost of the engine or engines are not separately identified.

Again, a deduction is allowed for the estimated cost of an overhaul with the value of that deduction determined under section DW 5(6).

Aircraft acquired new or that has had an engine overhaul immediately before acquisition

Section DW 5(6)(a) applies if the aircraft acquired is new or the aircraft engine has been recently overhauled. The allowable deduction is the estimated cost of an overhaul of the engine, determined as at the time of acquisition. The application of section DW 5(6)(a) is illustrated in Example 7.

Example 7: Application of section DW 6(4)(a) (engine cost not identified)

Aircraft acquisition cost of $1.4m.

Estimated cost of an overhaul at acquisition is $450,000.

The allowable deduction is $450,000.

The base value of the aircraft is: $1,400,000 – $450,000 = $950,000

Aircraft acquired with engine part-way through its overhaul cycle

Section DW 5(6)(b) allows a deduction to an aircraft operator for an amount equal to the estimated cost of an engine overhaul at acquisition, after taking into account the maintenance condition of the engine at acquisition. The adjustment is determined by the amount of time that is still to run before the engine is due for its next overhaul.

The aircraft operator is required to apportion the estimated cost of the overhaul amount between the expired and the unexpired portion of that estimate (based on relevant use measures). The expired portion is included in the cost base of the aircraft under the depreciation rules (as part of the base value) and the unexpired portion is the allowable deduction. The application of section DW 5(6)(b) is illustrated in Example 8.

Example 8: Application of section DW 5(6)(b) (engine cost not identified)

Aircraft acquisition cost of $1.4m.

Estimated cost of an overhaul at acquisition is $450,000.

The time between engine overhauls is 3,000 hours and the unexpired time in the overhaul period at acquisition is 2,800 hours.

The calculation under section DW 5(4)(b) is:

450,000 × 2,800 ÷ 3,000 = $420,000

The allowable deduction is $420,000.

The base value of the aircraft for depreciation purposes is: $1,400,000 – $420,000 = $980,000

Apportionment of cost of aircraft on an approved basis

Under section DW 5(6)(c), an aircraft operator that maintains a fleet of aircraft is permitted to use historic data (from either internal or market sources) to apportion the total cost of an aircraft between the base value for deprecation purposes and the aircraft engine overhaul component. For this method to be adopted for valuing the deduction for the aircraft engine overhaul component, the basis of apportionment must be agreed with the Commissioner.

Replacement of components and parts in the overhaul process

Where a component or part is replaced as part of the overhaul process, section DW 6(8) treats the value of the replacement part installed in the engine as either:

- the adjusted tax value, if the component or part was an item of depreciable property; or
- the unexpired expenditure of the component or part, as determined under new section EA 3(4B).

If the part or component is an item of depreciable property prior to the 2017–18 income year (for example, a spare engine), the installation of the engine is treated as:

- a disposal of depreciable property for the purposes of the depreciation rules; and
- an overhaul of the engine.

For the purpose of the depreciation rules, the consideration on disposal when installing such an engine is equal to the adjusted tax value of the property (sections EE 45(12) and EE 46(11)). This ensures that there is no depreciation recovery income or loss on installation of a spare engine on hand at the beginning of the 2017–18 income year. The cost of the overhaul is treated as being equal to the adjusted tax value (section DW 6(8)).

At the beginning of the 2017–18 income year, the cost of items held in an operator's spare parts inventory (not being depreciable property) will have been previously deducted for income tax purposes in full (as repairs and maintenance). The tax value of this inventory will therefore be zero, and section BB 4(5) prevents any further allocation of that deduction to the 2017–18 or a later income year.

Example 9: Timing of deductions for components or parts

Company H acquired a tail rotor gearbox (Gearbox 1) for a helicopter on 30 June 2017, at a cost of $20,000, during the company's 2017–18 income year (balance date 31 March). Gearbox 1 is installed into the helicopter during an overhaul of the tail rotor system on 1 July 2017.

After 200 flying hours, Gearbox 1 is removed from the helicopter on 30 November needing some maintenance work. It was replaced by another gearbox from spare parts inventory (Gearbox 2). Gearbox 2 had a value of $1,200 at the beginning of the 2017–18 income year (Gearbox 2 was acquired in the 2011–12 income year for $18,000).

After completing the maintenance work, Gearbox 1 is returned to the spare parts inventory until 31 May 2018, when it is installed in another helicopter (same model) during an overhaul of that helicopter's tail rotor system.

For both gearboxes, the maximum number of flying hours before the gearbox must be overhauled (or replaced) is 3,600 flying hours.

Gearbox 1 – allocation of allowable deduction under the spreading rule

When Gearbox 1 is removed from the helicopter for maintenance, 200 flying hours have expired. Under the spreading rule (section EJ 24), the amount of the deduction of $20,000 allocated to the 2017–18 income year is calculated as:

200 ÷ 3,600 × $20,000 = $1,111

As Gearbox 1 has been returned to spare parts inventory, existing section EA 3(4) provides that the unexpired expenditure for Gearbox 1 would be calculated as:

3,400 ÷ 3,600 × $20,000 = $18,889

When Gearbox 1 is installed on the second helicopter as part of the overhaul of its tail rotor system, section DW 5(6) and section EA 3(4B) provide that the value taken into account for the spreading rule is the unexpired value ($18,889).

Gearbox 2 – accounting value of $1,200 at the start of the 2017–18 income year

The allowable deduction for Gearbox 2 was fully allocated to the 2011–12 income year as repairs and maintenance. Despite the gearbox having an accounting value of $1,200 at the start of the 2017–18 income year, the tax deduction for the cost of the gearbox has been allocated in full prior to this income year.

Section BD 4(5) prevents the accounting value for the Gearbox 3 ($1,200 being taken into account in the 2017–18 or any future income year and ensures that no double deduction can occur for engine components and parts acquired prior to the 2017–18 income year.

Aircraft operators having one aircraft

An aircraft operator that owns a single aircraft may elect, under section EJ 26, not to apply the spreading rule in section EJ 27. The election must be notified in relation to an income year to the Commissioner either before, or at the time of making the annual return of income for that year.

This election cannot be made by a person who, together with an associated person,

- operates more than one aircraft in any type of business (if the association is not by blood relationship); or
- operates more than one aircraft in a particular business with another person who is associated by blood relationship (for example, two partners in a farming business who each own an aircraft, but operate both aircraft in that farming business).

Section EJ 26(2) provides that the cost of an aircraft engine overhaul is allocated to the year the expenditure is incurred.

If this election is made, sections DW 5(7) and DZ 22(1)(d) ensure that an aircraft operator who makes this election is not allowed a deduction:

- for the estimated value of an engine overhaul on acquisition of an aircraft or an engine under section DW 5(3) or (5); and
- the adjusted tax value of the aircraft engine component for existing aircraft owned by the operator at the beginning of the 2017–18 income year.

In addition, section EJ 26(3) provides that the election has a continuing effect unless the aircraft operator either:

- revokes the election with effect from a particular income year; or
- no longer meets the single aircraft requirement.

However, if the aircraft operator is unable to meet the single aircraft requirement, a period of "grace" exists, of three consecutive income years. This period of "grace" ensures that a single aircraft operator may acquire a second aircraft and continue to have two aircraft in the business pending disposal of the first aircraft.

Aircraft operators owning aircraft under a finance lease

For income tax purposes, an aircraft operator that leases an aircraft under a finance lease (for income tax purposes) is treated as having acquired the aircraft, with the aircraft being financed by a loan from the lessor.

The value of the aircraft and the loan are determined under sections EW 32 and EW 33 of the Income Tax Act 2007, and the financing costs of the lease are spread under the financial arrangement rules.

However, leases for aircraft may also contain maintenance and return conditions, which are mainly to:

- protect the lessor's investment in the leased asset during the term of the lease; and
- protect the lessor from the credit risk that the lessee may not be able to meet redelivery conditions in the lease that require the lessee to return the aircraft or aircraft engine in a stipulated part- or full-life condition.

These conditions generally impose an obligation on the lessee to either:

- pay regular maintenance reserve payments during the term of the lease to provide a fund on which the lessee can draw on to pay for overhauls during the term of the lease or which the lessor can draw on if the lessee does not return the aircraft in the agreed life-condition; or
- pay an end-of-lease adjustment (which may be supported during the lease by a letter of credit) to the lessor if the aircraft is returned at less than the agreed life-condition.

In cases where the aircraft is returned at better than the agreed life-condition, leases often provide for the lessor to make an end-of-lease adjustment payment to the lessee.

Maintenance reserve payments provide a fund for an aircraft operator or lessor to draw on when an overhaul is due. As a deduction is allowed for the actual cost of an aircraft engine overhaul (section DW 5(2)), new section DW 6 ensures that maintenance reserve payments made by the lessee to the lessor are not an allowable deduction. This ensures that the rules in sections DW 5(2) and EJ 24 work as intended and do not permit reserve payments to advance the timing of the deduction for aircraft engine overhaul expenses.

However, at the expiry of the lease, if the total amount of maintenance reserve payments made to the lessor during the term of the lease exceeds the amounts drawn out of that reserve fund by the lessee, the excess amount is a deduction under section DW 6(3) to the extent the amount is not refundable to the lessee. This deduction is allocated to the income year in which the lease expires.

An end-of-lease adjustment payment made to the lessor (or vice versa) relates to the maintenance condition of the aircraft at the expiry of the lease. Therefore, an end-of-lease payment made by the lessee to the lessor is an allowable deduction under section DW 6(4) and is allocated to the income year the lease expires.

Similarly, an end-of-lease payment made in the reverse direction (lessor to lessee) represents a reimbursement to the lessee for returning the aircraft in a life-condition better than agreed in the lease. In effect, such a payment is a reimbursement of previously incurred overhaul expenditure and so this amount is income of the lessee under section CG 4 in the year the lease expires.

Transitional matters

Transitional deduction for adjusted tax value of aircraft engine

Sections DZ 22 and EZ 23BA apply to an aircraft operator for each aircraft owned at the beginning of the 2017–18 income year. These two provisions work in tandem to allow and allocate a deduction for the adjusted tax value of an aircraft engine owned by an aircraft operator at the beginning of the 2017–18 income year.

The purpose of these two sections is to:

- align the tax treatment of aircraft engine overhaul components for aircraft owned at the end of the 2016–17 income year with the proposal to remove the aircraft engine overhaul component from the depreciation rules;
- reduce the depreciable cost of each aircraft (base value) and depreciated tax value of each aircraft (adjusted tax value) as at the beginning of the 2017–18 income year; and
- provide a linkage to the depreciation rules, which are consequentially amended to reduce base value, adjusted tax value, and total depreciation.

Section DZ 22

Section DZ 22(2) or (3) allows a deduction for the adjusted tax value of the overhaul component of an aircraft engine owned at the beginning of the 2017–18 income year. The amount of this deduction is valued from the interaction of sections DZ 22(1)(c) and EZ 23BA.

Section DZ 22 does not apply to an aircraft operator who elects out of the spreading rule under section EJ 26 (single aircraft operator election). Section DZ 22(3) and (3) also sets out how the deduction is to be allocated to an income year.

Section EZ 23BA

Section EZ 23BA is a valuation rule which requires an aircraft operator to estimate how much of the cost of the engine corresponds to the cost of an aircraft engine overhaul (termed "engine overhaul component" here).

To minimise the compliance costs that might arise if actual records are not readily available, this estimate can be determined from any one or more of:

- the aircraft operator's own accounting records at acquisition;
- market-based information at the time of acquisition; or
- a fair and reasonable estimate based on either or both of the principles set out in section DW 5 (see discussion earlier in this *Tax Information Bulletin* item) or historical data.

Once that value is determined, the proportion of that estimated cost to the original cost of the engine (separate item of depreciable property) or aircraft (item of depreciable property including an engine or engines) is applied to determine:

- how much of the cost of the engine or aircraft (base value) relates to the engine overhaul component;
- how much of the written down tax value (adjusted tax value) for the engine or aircraft relates to the aircraft engine overhaul component; and
- the amount of accumulated tax depreciation (total deduction) that relates to the engine overhaul component.

The amount of the deduction allowed under section DZ 22 is equal to the amount of the adjusted tax value that relates to the aircraft engine overhaul component, as determined under section EZ 23BA.

Prior to the 2017–18 income year, the aircraft was treated as an item of depreciable property in its entirety. The changes to the deductibility and timing for aircraft engine overhaul expenses also ensure that the overhaul component of an aircraft engine at acquisition is amortised based on time-in-service and not under tax depreciation rates.

Consequently, amendments to the depreciation rules ensure that the aircraft's base value (cost) and total deduction (accumulated tax depreciation) are adjusted to give the correct adjusted tax value after taking into account the effect of the transitional deduction.

The adjusted tax value for the aircraft (depreciable property) after transition will continue to be the difference between the base value (as adjusted) and the total deduction (as adjusted). In addition, section EE 7 has been amended to ensure that the aircraft engine overhaul component is excluded from being depreciable property and that the aircraft itself remains depreciable property.

The apportionment under section EZ 23BA and consequential amendments to the depreciation rules are both illustrated in Example 10.

Example 10: Application of section EZ 23BA base value and related amendments in the depreciation rules

Company X is an aircraft operator and owns two aircraft at the beginning of the 2017–18 income year. Both aircraft are assumed to be of the same type, and the apportionment of the base value, total depreciation deductions and adjusted tax value is made on a fair and reasonable basis, determined as 20% from historical data of the operator. Aircraft 1 had its first engine overhaul during the 2013–14 income year. Aircraft 2 is due for its first engine overhaul in the 2019–20 income year.

As at the beginning of the 2017–18 income year:	**Adjusted tax value**	**Total depreciation deduction**	**Base value**
Aircraft 1:	$250,000	$750,000	$1,000,000
Aircraft 2:	$800,000	$200,000	$1,000,000

Amount of the transitional deduction under section DJ 22

Aircraft 1

Reduction in adjusted tax value (= section DZ 22 deduction) = $250,000 × 20% = $50,000

Aircraft 2

Reduction in adjusted tax value (= section DZ 22 deduction) = $800,000 × 20% = $160,000

Each aircraft's base value and adjusted tax value at the beginning of the 2017–18 income year

Aircraft 1

Reduced base value (base value less allowable deduction in transition)

$1,000,000 – $50,000 = $950,000

Adjusted tax value of aircraft after transitional deduction

(Reduced base value less total depreciation deduction at start of 2017–18 income year)

$950,000 – $750,000 = $200,000

Aircraft 2

Reduced base value (base value less allowable deduction in transition)

$1,000,000 – $160,000 = $840,000

Adjusted tax value of aircraft after transitional deduction

(Reduced base value less total depreciation deduction at start of 2017–18 income year)

$840,000 – $200,000 = $640,000

Allocation (timing) of the transitional deduction

Section DZ 22(2) applies if an overhaul of the aircraft's engine has occurred prior to the 2017–18 income year. In this case, the allowable deduction is allocated to the 2017–18 income year.

Section DZ 22(3) applies if the first overhaul of the aircraft's engine occurs after the start of the 2017–18 income year. In this case the allowable deduction is allocated to the 2017–18 income year and later income years, based on the most appropriate measure of use for the aircraft and the unexpired scheduled overhaul period.

The application of these two timing rules is illustrated in Example 11.

Example 11: Allocation of transitional deduction

Company X is an aircraft operator and owns two aircraft at the beginning of the 2017–18 income year. Both aircraft are assumed to be of the same type, and the apportionment of the base value, total deduction and adjusted tax value is made on a fair and reasonable basis, determined as 20% from historical data of the operator. Aircraft 1 had its first engine overhaul during the 2013–14 income year. Aircraft 2 is due for its first engine overhaul in the 2019–20 income year.

The transitional deduction for each aircraft is as follows: Aircraft 1 = $50,000, and Aircraft 2 = $160,000

Under section DZ 22(2), the transitional deduction for Aircraft 1 is allocated in full to the 2017–18 income year.

Under section DZ 22(3), the deduction for $160,000 is to be spread between the 2017–18 and subsequent income years based on actual time-in-service during each of those income years, and time-in-service remaining in the current scheduled overhaul period.

Assume 1,000 hours of time-in-service remain in the current scheduled overhaul period (3,000 hours) as at the beginning of the 2017–18 income year. Assume the following time-in-service hours from the 2017–18 income year.

2017–18 income year: 400 hours
2018–19 income year: 350 hours
2019–20 income year: 250 hours

The allocation of the deduction of $160,000 under section DZ 22(3) using the following assumed time-in-service from 2017–18 is calculated as follows:

2017–18 income year: $160,000 – ($160,000 × 600÷3,000) = $128,000
2018–19 income year: ($160,000 – $128,000) × (350÷600) = $18,667
2019–20 income year: ($160,000 – $128,000) × (250÷600) = $13,333

Total deduction allocated: $128,000 + $18,667 + $13,333 = $160,000

Recovery of aircraft maintenance tax accounting provisions

Section DZ 23 applies to a person who, prior to the 2017–18 income year, has used a provisioning accounting methodology as follows:

- to value a deduction (based on an estimate of future aircraft overhaul expenditure) in the calculation of taxable income for a tax year before the 2017–18 income year; if
- the amount of the provision relates to overhaul expenditure that is not incurred until after the beginning of the 2017–18 income year.

The accrued unused provisions are to be either:

- offset against the cost of the next succeeding overhaul; or
- treated as income under section CG 2 of the Income Tax Act 2007 on disposal of the aircraft.

Offsetting provisions against next succeeding overhaul

Aircraft engine overhaul provisions

If the provisions are accrued on an item-by-item basis (for example, by serial number or part number), the reversal against the actual overhaul cost should be made against the relevant overhauled or retired part. If the provision is for an overhaul rather than an individual component or part, the value of an accrued provision for an aircraft engine overhaul against the related overhaul expenditure (for helicopters this would be matched to the relevant overhaul on a system by system basis).

It may be possible that the accrued provision for an aircraft engine overhaul at the end of the 2016–17 income year may exceed the actual aircraft engine overhaul cost when incurred. In this case, the excess amount is carried forward and applied against the cost of the next relevant overhaul. This has the effect, in transition, of:

- reducing the amount of the allowable deduction for an aircraft engine overhaul after the beginning of the 2017–18 income year;
- ensuring that the aircraft operator does not receive a deduction for both the provision for future overhaul expenses prior to the 2017–18 income year and again when the actual expenditure was incurred; and
- spreading the tax effect of reversing a provision for aircraft engine overhauls over a number of years.

Provisions for non-engine overhauls

If the provision includes an amount for a non-engine overhaul (for example, airframe check or landing gear), the amount of the provision is to be offset against the incurred cost for that non-engine overhaul.

For example, if an aircraft operator has accrued a provision of $50,000 for an overhaul of landing gear up to the end of the 2016–17 income year, the full amount of the provision is offset against the cost of the landing gear overhaul.

In all cases, if the amount of a provision for a non-engine overhaul exceeds the cost of the non-engine overhaul, that excess is treated as income in the year of the overhaul under section CZ 34.

Example 12: Application of section DZ 23(3)

Company A has an accrued provision of $20,000 at the beginning of the 2017–18 income year for the replacement of the main rotor blades on a Bell Jetranger helicopter.

The next overhaul is scheduled to occur after another 3,900 hours of flying time. Deductions allowed for that accrued provision for tax years before the 2017–18 income year are not adjusted. However, no further deductions are allowed for a provision for future overhaul expenditure as the amount of a provision will not meet the requirements to be an allowable deduction.

The next scheduled replacement of the rotor blades is expected to cost approximately $100,000. The accrued provision of $20,000 is offset against the cost of that next scheduled overhaul, resulting in the allowable deduction being $80,000. That deduction is then spread across the following scheduled overhaul period under section EJ 24 (or section EJ 25 for IFRS taxpayers).

IFRS taxpayers

Section EJ 25 provides that aircraft operators who are required to adopt IFRS[19] for financial accounting purposes may agree a method with the Commissioner to value and allocate deductions allowed under section DW 5, based on their IFRS accounting treatment.

This election is restricted to taxpayers that:

- are a New Zealand resident; or
- hold a valid certificate of registration for the aircraft from the Director of Civil Aviation.

Disposal of aircraft

Section EJ 27 applies, on disposal of an aircraft, to recover deductions for aircraft engine overhauls (including the deduction allowed under section DW5(3) and (4)). The effect is similar to that on disposal of depreciable property.

Section EJ 27(2) provides that the unexpired portion of a deduction allowed under section DW 5 (determined as at the date of disposal) is to be allocated to the year of disposal.

Section EJ 27(3) requires the consideration derived on disposal to be apportioned between the item of depreciable property (the aircraft or engine) and the amount attributable to the engine overhaul component. The basis for the apportionment must be either agreed with the purchaser or be on a fair and reasonable basis if there is no agreed apportionment with the purchaser (for example, when the consideration is for the aircraft as a whole).

The portion of the consideration attributable to the depreciable asset is to be taken into account as consideration on disposal of an item of depreciable property under the depreciation rules.

The portion of the consideration relating to the engine overhaul component is income under section CG 9. However, section EJ 27(5) limits the amount of this income to the lesser of:

- the total deduction allowed under section DW 5 for the current scheduled overhaul period; and
- the portion of the consideration attributable to the engine overhaul component.

Any amount in excess of this limit set in section EJ 27(5) is not income of the taxpayer and is intended to be treated as a capital gain. This is the same outcome as applies for consideration on disposal of an item of depreciable property that is in excess of the cost of the asset.

Consequential amendments to the finance lease rules

The amendment to section FA 9 ensures that if the lessee acquires the lease asset at the end of a lease, the amount of a deduction allowed to a lessee under section DW 5 or DW 6 is not treated as part of the original cost of the aircraft as a whole.

[19] International Financial Reporting Standards

This ensures that income derived under section CC 1 from a subsequent sale of the aircraft by the lessee or associated person is measured against the correct cost base.

The amendment to section FA 10 ensures that an end-of-lease payment made on redelivery of the leased aircraft or engine (for example, life-condition payments) are not included in the amount of consideration under section FA 10 if that payment is an allowable deduction under sections DW 5 or DW 6.

The amendment to section FA 11 ensures that the amount of a deduction allowed under section DW 5 or DW 6 is not included in the adjustment calculation for an operating lease that becomes a finance lease.

Clarification of empowering provision for New Zealand's double tax agreements

Section BH 1 of the Income Tax Act 2007

The Income Tax Act 2007 has been amended to clarify that the empowering provision for New Zealand's double tax agreements (DTAs) does not prevent the general anti-avoidance rule contained in the Income Tax Act 2007 from applying to a tax advantage arising under a DTA.

A further remedial change to the empowering provision has been made to ensure it operates as intended in relation to the process for bringing DTAs into force.

Background

New Zealand, like many other countries, has a general anti-avoidance rule (GAAR) in its income tax legislation. Section BB 3 provides that the GAAR overrides other provisions in the Income Tax Act 2007 to deny the tax benefits of an arrangement if a more than incidental purpose of that arrangement is to obtain a tax benefit and the tax benefit is outside Parliament's contemplation for the relevant provisions. The GAAR applies to all income tax transactions, including those with an international dimension (that is, New Zealand residents investing offshore or non-New Zealand residents investing in or through New Zealand).

New Zealand also has anti-avoidance rules that target specific avoidance behaviour. These are known as specific anti-avoidance rules (SAARs). These rules also apply to transactions with an international dimension. Unlike the GAAR, SAARs are not expressed as having overriding effect.

DTAs are international treaties that are entered into primarily to prevent double taxation on cross-border income. To achieve this, DTAs may limit the tax that can be imposed by the country of source or residence, or require a tax credit to be provided for foreign tax paid. Section BH 1(4) provides that DTAs generally have overriding effect despite other provisions in the Income Tax Act 2007.

On the face of the legislation there is a potential conflict between the GAAR and the provision that empowers New Zealand's DTAs – because both provisions are expressed to be overriding. Before enactment of the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill, the legislation was not explicit about the ordering between the provisions that govern the domestic implementation of DTAs and the GAAR.

Because of this it had been suggested that, because the Income Tax Act 2007 did not explicitly address the relationship between New Zealand's DTAs and its anti-avoidance rules (in particular the GAAR), it was possible to argue that section BH 1 prevented the GAAR from applying to a DTA. It had also been argued that the GAAR may have been prevented from applying when a DTA prescribes a specific outcome, for example, where a defined term in a DTA mandates the treatment that the Commissioner of Inland Revenue is seeking to counteract under the GAAR.

The amendment introduced by the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 clarifies that the provision that empowers New Zealand's DTAs (section BH 1) does not prevent the GAAR contained in income tax legislation from applying to counteract a tax advantage arising under a DTA. This is consistent with Inland Revenue's current practice and interpretation of the Income Tax Act 2007 before the amendment.

As well as providing that DTAs have overriding effect, section BH 1(3) also authorises the making of Orders in Council to give effect to New Zealand's DTAs. The new legislation also introduces a minor remedial amendment to ensure it operates as intended in relation to the process for bringing DTAs into force.

Key features

Interaction between section BH 1 and the GAAR clarified

Section BH 1(4) of the Income Tax Act 2007 has been amended to explicitly refer to section BG 1 (Tax avoidance), clarifying that section BH 1(4) does not prevent the GAAR from applying in situations when a DTA applies.

This amendment makes it explicit in legislation that the GAAR can apply to deny a tax advantage obtained from a tax avoidance arrangement, whether the tax advantage arises under domestic law or a provision of a DTA.

Process for DTAs coming into force

In addition, a remedial amendment to section BH 1(3) ensures that the legislation better reflects the process through which a DTA enters into force. That is, section BH 1(3) has been amended to refer to a DTA entering into force as declared by the Governor-General by Order in Council and on the date determined under the DTA.

Application date

The amendments came into force on the date of enactment, being 30 March 2017.

Detailed analysis

Interaction between section BH 1 and the GAAR

Section BH 1 contains the empowering provision for DTAs. Subsection BH 1(4) provides that despite other provisions in an Inland Revenue Act, the Privacy Act 1993 or the Official Information Act 1982 (except for section BH 1(5) and (5B)), DTAs have overriding effect in relation to income tax, any other tax imposed by the Income Tax Act 2007, and the exchange of information that relates to a tax.

Section BG 1 (the GAAR) provides that a tax avoidance arrangement is void as against the Commissioner of Inland Revenue for income tax purposes. Section BG 1 is also expressed to have overriding effect under section BB 3.

As both DTAs and the GAAR are expressed as having overriding effect with respect to income tax, the amendment in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 clarifies that the GAAR has the ultimate overriding effect.

Amended section BH 1(4) therefore includes an explicit reference to section BG 1, to clarify that a DTA does not have overriding effect with respect to the GAAR.

This approach is consistent with Inland Revenue's view of the law before enactment of the new legislation.

The amendment applies for all DTAs, irrespective of the date they entered into force. In other words, Inland Revenue does not currently take a different approach to avoidance cases depending on the date the treaty was concluded. While some people might disagree, as a technical matter, with Inland Revenue's view in respect of DTAs concluded before 2003 (or 1992) because of changes to the OECD Commentary, in principle, the position should not depend on the age of the DTA – the GAAR should always have overriding effect. Therefore, the change to the legislation is merely to clarify the domestic law and resolve any uncertainty on this point.

Interaction with international law

New Zealand's DTAs are based on the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (the OECD Model Tax Convention). The accompanying commentary to the OECD Model Tax Convention (the OECD Commentary) is an important part of the context in which these DTAs are internationally understood.

The OECD Commentary states that, as a general rule, there will be no conflict between GAARs and the properly constructed provisions of DTAs. It also confirms that States are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that it should not be lightly assumed that the DTA has been abused).

The 2015 Final Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) was published as part of the OECD's Base Erosion and Profit Shifting (BEPS) project and provides further analysis of this issue – reinforcing the position that in the majority of cases there will be no conflict between a GAAR and the provisions of a DTA when both are properly constructed. The analysis in this report has now been incorporated into the OECD Commentary.

In almost all cases, no conflict should arise between a DTA and the GAAR. While a conflict could theoretically result in a treaty override, this issue is largely academic and arises for all countries that have the same law regarding their GAAR, not just New Zealand. These countries include Australia, the United Kingdom and Canada, which have also provided clarification in their domestic legislation that their GAAR overrides DTAs.

Application of the GAAR in the context of a DTA

As noted above, the Commissioner of Inland Revenue's current practice and interpretation of the law is that the GAAR is able to apply in the context of a DTA. The amendment reduces uncertainty by making this explicit.

Under the GAAR, a tax avoidance arrangement is void as against the Commissioner of Inland Revenue. The Commissioner of Inland Revenue may then reconstruct the arrangement to counter tax advantages under section GA 1.

In principle, the GAAR applies to tax avoidance arrangements involving a DTA in the same way as it applies to tax avoidance arrangements that do not have a DTA aspect. There is a large body of case law on the GAAR, which generally provides considerable guidance on how it will apply in specific cases. In addition, comprehensive guidance on the application of the GAAR can be found in the Commissioner of Inland Revenue's Interpretation Statement IS 13/01 "Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007". This Interpretation Statement contains a detailed analysis of the Commissioner of Inland Revenue's power of reconstruction, including a discussion of when the Commissioner will reinstate legitimate tax outcomes voided by the arrangement.

If a transaction has been reconstructed by the Commissioner of Inland Revenue as a result of applying the GAAR, a legitimate treaty benefit can be reinstated in the same way as in the case of a domestic tax law benefit. For example, if the proceeds of a share sale are recharacterised as a dividend under domestic law due to the application of the GAAR, then subject to the requirement that the provision of treaty benefits is a legitimate tax outcome, the dividend article of the relevant DTA would apply to the recharacterised proceeds.

In other cases, no relief will be available. For example, a person who artificially inserts an entity into a jurisdiction that has a DTA with New Zealand in order to benefit from a lower withholding tax rate under a DTA would not be entitled to treaty relief under that DTA.

It should be noted that the Commissioner of Inland Revenue is not obliged to reconstruct a transaction. For example, the Commissioner of Inland Revenue can simply treat a transaction as void (that is, assume the transaction did not take place). In that case, no treaty relief would be available in New Zealand as if no transaction took place.

As noted above, in the Commissioner of Inland Revenue's view, the practical outcomes from an application of section BG 1 in this context are effectively determined in the same manner as when the avoidance is in relation to domestic provisions.

Binding rulings are available to provide certainty to taxpayers and are available to taxpayers who are concerned that a transaction may be subject to the GAAR (including where a DTA applies).

Furthermore, the Action 6 Report (and the updated OECD Commentary) provides guidance on the interaction of domestic law anti-avoidance provisions and DTA provisions. It also provides examples of how the new treaty anti-abuse provision (the "principal purpose test") would apply to specific fact patterns.

Specific anti avoidance rules (SAARs)

The amendment applies only to the GAAR, not to the specific anti-avoidance rules (SAARs). The rationale for clarifying that the GAAR may still apply is because the Income Tax Act 2007 expresses both the GAAR and DTAs as having overriding effect.

The OECD Action 6 Final Report provides that conflicts between SAARs and DTAs will be avoided by a proper construction of both. New Zealand follows relevant OECD Commentary guidance in determining whether there is a conflict between a SAAR and a DTA. In rare cases when a proper construction of the SAAR and a DTA nevertheless results in a conflict, the provisions of the DTA would prevail.

Overseas donee status

Schedule 32 of the Income Tax Act 2007

The following charities have been granted donee status from the 2016–17 income year:

- Astha Childrens Home (Nepal/New Zealand)
- Cambodia Trust (Aotearoa-New Zealand)
- Destiny Rescue Charitable Aid Trust
- First Steps Himalaya
- Fountain of Peace Children's Foundation New Zealand
- GC Aid

- Hornsby Pacific Education Trust
- Mercy Mission of New Zealand Trust Board
- Microdreams Foundation New Zealand Humanitarian Trust
- NPH New Zealand Charitable Trust
- Orphans Refugees and Aid (ORA International) of NZ Charitable Trust
- Siphala Foundation
- Solomon Outreach Society
- Toraja Rural Development Charitable Trust.

Changes to other charities listed on schedule 32 have also been made, as follows:

- "New Zealand Red Cross Incorporated" replaces "The Red Cross Society Incorporated" with effect from 14 December 1993.
- "Youth Education and Training Initiatives (YETI) Nepal Trust" replaces "The Destitute Children's Home, Pokhara, Charitable Trust" with effect from 1 April 2013.
- Bicycles for Humanity, Auckland is removed from the list with effect from 3 December 2015.

Background

New Zealand-based charities who apply some or all of their funds for overseas purposes and who want donors to receive tax benefits in connection with any donations received, are required to be named as a donee organisation on the list of recipient of charitable or other public benefit gifts in the Income Tax Act 2007.

Donee status entitles individual donors to a tax credit of 331/3 percent of the amount donated to these organisations, up to the level of their taxable income. Companies and Māori authorities are eligible for a deduction for monetary donations up to the level of their net income.

Application dates

The new insertions apply from the 2016–17 and later income years. The other changes to the schedule apply from the dates specified above.

Land tainting and council-controlled organisations

Sections CB 9, CB 10, CB 11, CB 15C, CV 2, CW 39 and FM 9 of the Income Tax Act 2007

Amendments have been made to the Income Tax Act 2007 to exclude entities controlled by local authorities from the land tainting rules. This exclusion does not apply when an entity controlled by a local authority is associated with a property development entity that operates outside the council group.

Consequential amendments have also been made to ensure that income does not arise under the consolidated group rules as a result of new subsection CB 15C(1).

The local authority income tax exemption has also been amended to ensure that it applies to income derived by a local authority from transactions with unrelated council-controlled organisations (CCOs), port companies or energy companies.

Background

Land tainting

The land tainting rules contained in sections CB 9 to CB 11 were introduced to prevent tax avoidance but overreached in the context of council groups by taxing capital account land in situations when there was no tax avoidance concern.

Under the rules, a person who is associated with a land developer, dealer or builder may be taxed on a disposal of land, notwithstanding that they would not be taxable on the sale in the normal course of events. Overreaching of the provisions occurred when the disposal of land used by a CCO for the purposes of delivering council services became taxable because another CCO was involved in property development.

There is no tax avoidance concern in this context for the following reasons:

- Council-controlled organisations are holding land necessary for their operations to ensure they are individually accountable for the use of the land and able to more easily make commercial decisions in relation to the land, not to avoid tax for a developer in the group.

- Many affected CCOs have held land prior to any entity in the group being considered a property developer.
- If a council group were intending to avoid tax, it would not develop land in a taxable entity, nor would it hold land in its taxable CCOs. Instead, the local authority would undertake the development itself and lease all necessary land to its CCOs. This would have no tax effect, as the payments would be taxable to the local authority (local authorities are generally exempt from tax, but not on income derived from their CCOs) but deductible to the CCOs.
- Council-controlled organisations operate independently of each other, with distinct business objectives. Each organisation has its own separate board and makes decisions without reference to the council or the other CCOs. Therefore, any land held by a CCO is likely to be unrelated to the development activities of another entity within the group.

The policy intent behind the amendment is to exclude entities within the council group from the land tainting rules to prevent the overreach described above.

Consolidated groups

Section FM 9 applies when a company that is part of a consolidated group derives an amount that would not ordinarily be income of the company but would be income of the consolidated group if it were one company. The section provides that the amount is income of the company under section CV 2. This provision is intended to prevent intra-group arrangements where assets are transferred and re-characterised to avoid tax.

The effect of these sections is that any land disposed of by a CCO (even if excluded from the land tainting rules as provided for by new section CB 15C) would be taxable to the council group because of the development activities of another group member.

Local authority tax exemption

Under section CW 39(4) of the Income Tax Act 2007, an amount of income a local authority derives from a CCO or a port or energy company (that would be a CCO in the absence of section 6(4) of the Local Government Act 2002) is taxable. This represents an exclusion from the general income tax exemption afforded to local authorities by section CW 39(2). It was introduced in 1989 to ensure that a CCO is treated as an ordinary company for tax purposes in relation to its commercial operations. The policy intent was to ensure competitive neutrality of CCOs with the private sector. Without this provision, the policy intent could be defeated, as income from a CCO could effectively be extracted tax-free by the local authority charging the CCO rental or management fees, which would be deductible to the CCO but not taxable to the local authority due to its tax-exempt status.

Section CW 39(4) refers to CCOs, port companies and energy companies generally, instead of these entities being owned or controlled by the local authority with the tax exemption. Before the amendments, this meant that, if, for example, a local authority were to develop land, its sales to private buyers would be exempt from tax but any sale to an unrelated entity, which happened to be a CCO, port company or energy company because of some other local authority's ownership or control, would be taxable. This was unintended.

Key features

Land tainting

New section CB 15C of the Income Tax Act 2007 provides an exclusion from the land tainting rules contained in sections CB 9(2), CB 10(2) and CB 11(2), and applies to entities controlled by or associated with a local authority.

The exclusion does not apply to:

- entities associated with a local authority under the tripartite relationship test in section YB 14; and
- entities associated to a property developer when that developer is outside the council group, unless that association occurs under section YB 14.

Consolidated groups

Section CB 15C(2) and amendments to sections FM 9 and CV 2 ensure that income does not arise under the consolidated group rules for transactions that would otherwise be exempt under section CB 15C(1).

Local authority tax exemption

Section CW 39 has been amended to ensure the exemption applies to income derived by local authorities from transactions with unrelated CCOs, port companies or energy companies.

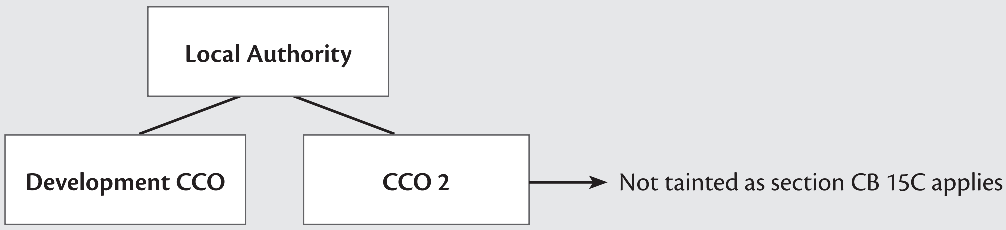
Detailed analysis

Example: Section CB 15C

A local authority has two wholly owned subsidiaries (Development CCO and CCO 2 in the diagram below). Development CCO is a property developer (person B for the purposes of section CB 15C) and CCO 2 is responsible for roads and parking (person A for the purposes of section CB 15C).

Under section CB 15C any land sold by person A will be excluded from the application of the land tainting rules because both persons A and B are CCOs owned by the same local authority and so section CB 15C(1)(a) and (b) are met.

Example 1



Example 2: Entity associated with local authority and a property developer under section YB 14

A local authority wholly owns a subsidiary which provides rubbish collection services (CCO in the diagram below).

The local authority and the CCO are associated under section YB 2 as the single notional person shareholder of the local authority (not shown in the diagram) holds 100 percent of the voting interests in the local authority and the CCO (sections YC 4 and YC 5).

The local authority and a third-party property developer (developer in the diagram below) are associated with a trust which provides social rental accommodation services, as both the local authority and the property developer have the power to appoint or remove the trustee(s) of the trust (a section YB 11 association).

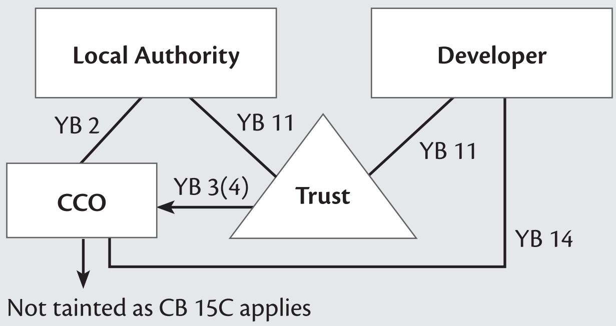
Under section YB 3(4) the CCO and the trust are associated as the trust is treated as holding what the local authority holds because the local authority and the trust are associated under section YB 11.

As a result the CCO and the developer are associated through the operation of section YB 14 (associated with the trust under different associated person tests – section YB 3(4) and section YB 11).

Under section CB 15C, any land sold by the CCO (person A for the purposes of section CB 15C) will be excluded from the application of the land tainting rules because the CCO and the developer (person B for the purposes of section CB 15C) meet the tests for person A and person B in section CB 15C(1)(a)(i) and (1)(b)(ii).

It is intended that the CCO is exempt in this situation as the developer is outside the council group and exerts no control over the CCO, so there is no tax avoidance concern.

Example 2



Example 3: Development within council group but external entity has control over a council entity

A local authority has a property development subsidiary. The local authority is also in partnership with a private company to improve the city's water supply.

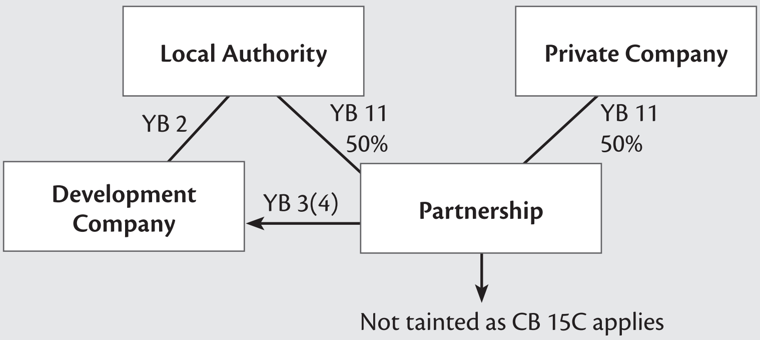
The local authority and the private company are associated with the partnership under section YB 12 as they are partners in the partnership.

Under section YB 3(4) the development company and the partnership are associated as the partnership is treated as holding the local authority's 100 percent ownership in the development company because the partnership and local authority are associated under section YB 12.

Under section CB 15C, any land sold by the partnership (person A for the purposes of section CB 15C) will be excluded from the application of the land tainting rules because both person A and the development company (person B for the purposes of section CB 15C) meet the tests for person A and person B in section CB 15C(1)(a)(iii) and (1)(b)(i).

The example shows that where the property development activity occurs within the council group but an external entity still exerts control over a council entity, the council entity will still be exempt as it is considered that there is no tax avoidance concern when the development occurs within the group.

Example 3



When section CB 15C does not apply

Example 4: Entities associated with a local authority under the tripartite relationship test

A local authority has entered into a partnership to develop land with a private company (Company 1 in the diagram below). The private company also owns another company (Company 2 in the diagram below).

The local authority and the private company are associated with the partnership under section YB 12 as they are partners in the partnership. The partnership and Company 2 are associated under section YB 3(4) because Company 2 is treated as holding Company 1's ownership interest in the partnership because Company 1 and the partnership are associated under section YB 12.

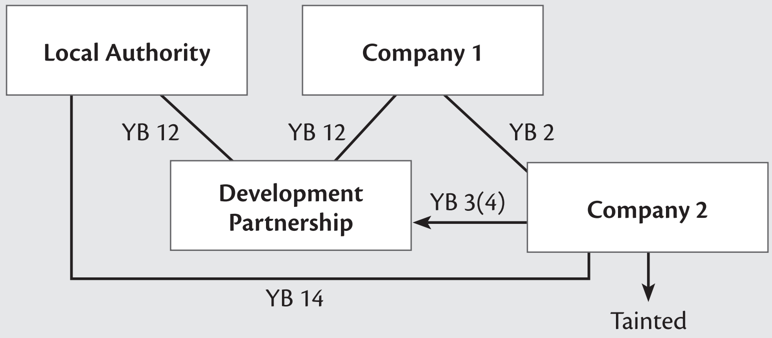
The local authority and Company 2 are associated under section YB 14 as they are associated with the development partnership under different associated persons tests – section YB 3(4) and section YB 12.

Land held by Company 2 would be tainted by the activities of the development partnership and potentially taxable on sale. Company 2 would not qualify for an exclusion from the tainting rules as it fails the "person A" test in section CB 15C(1)(a) because its association with the local authority is under section YB 14.

The policy intention behind carving out entities associated with a local authority under section YB 14 from the section CB 15C exclusion is so that entities outside the council group are not afforded the exemption.

NEW LEGISLATION

Example 4

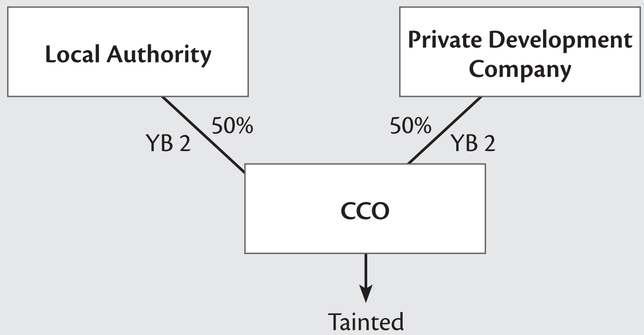


Example 5: Entities associated with a property developer (other than under section YB 14) and the developer is outside the council group

A local authority jointly owns a CCO with a private development company. This CCO will not qualify for the exclusion from the tainting rules in section CB 15C as the person B test in section CB 15C is not met (that is, the developer (person B) is associated with the CCO (person A) under section YB 2 and therefore does not meet section CB 15C(1)(b)(ii), which only allows an association under section YB 14).

Section CB 15C is not intended to apply to an entity directly associated with a property developer that operates outside the council group. There is a tax avoidance concern in this situation as the development entity may seek to avoid tax by holding properties in the name of the entity it jointly controls with the local authority.

Example 5



Application dates

The amendments to the land tainting rules and consolidated group rules apply from 1 September 2015, the date on which Auckland Council established a land development entity. The amendments will prevent land held by CCOs of Auckland Council from being tainted by the land development entity.

The amendment to the local authority tax exemption applies from the date of enactment, being 30 March 2017.

Loss offsets to mineral miners

Section IS 1 of the Income Tax Act 2007

An amendment to the Income Tax Act 2007 allows a company to make its tax loss available to a mineral miner that is part of the same group. This achieves a similar outcome to that available to mining holding companies before the repeal of those provisions in 2014.

Application date

The amendment applies for the 2014–15 and later income years. This date aligns with the application date of the current mineral mining rules.

Background

A mineral miner that is carrying forward tax losses and that breaches loss continuity due to an ownership change can continue to carry those tax losses forward to offset against future income from the same permit area. The trade-off for this concession is that a mineral miner cannot make their tax losses available to other members within their group.

Section IS 1(1) of the Income Tax Act 2007 previously restricted a mineral miner from being included in a group of companies that can use a tax loss from, or provide a tax loss to, another member of the group. This restriction was introduced to reflect the unique income tax treatment of mineral miners.

Before its repeal in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014, section IS 3 of the Income Tax Act 2007 overrode section IS 1(1) and allowed a mineral miner to use the tax loss of a mining holding company. Mining holding companies also previously had other purposes but were removed as part of the review of mineral mining tax rules completed in 2014.

The restriction on a mineral miner using the tax loss of another member from the same group has been removed as there is no policy reason why this restriction is necessary. The restriction on another member of the group using the tax loss of a mineral miner has been retained.

Attribution of mineral mining losses to shareholders of loss attributing qualifying companies

Sections HA 24 and IA 7 of the Income Tax Act 2007

An amendment to the Income Tax Act 2007 clarifies that a mineral miner that was a loss attributing qualifying company (LAQC) could attribute a net mining loss to its shareholders.

Application date

The amendment applies for the 2008–09 and later income years until 1 April 2011. This period aligns with the start of the Income Tax Act 2007 and ends with the repeal of the LAQC rules.

Key features

There is little policy justification for preventing the attribution of mining losses to shareholders in a LAQC. A retrospective amendment has validated past tax positions taken that attributed mining losses of a LAQC to its shareholders.

A "savings" provision ensures an LAQC that did not attribute a mining loss to its shareholders and does not request to amend their tax position is not required to do so.

Background

For some time there has been considerable uncertainty over the relationship between the mineral mining rules, the loss rules and the LAQC rules. The LAQC rules were repealed for income years beginning on or after 1 April 2011.

Due to the ring-fencing of mineral mining losses, it was not clear whether an LAQC could attribute a mining loss to its shareholders, consistent with the broad policy objective of attributing losses to shareholders of a LAQC.

Amendments to the mining rules from 1996 onward did not clearly deal with how taxpayers should treat a mining loss. This has led to different views on how to apply mining loss provisions to a LAQC.

The Income Tax Act 2007 clarified the law to reflect the original policy intention that all ring-fenced losses (including mineral mining losses) could only be used as set out in the specific loss rules.

Sharing of non-personal information under an approved information sharing agreement

Sections 81A and 87 of the Tax Administration Act 1994

The tax secrecy rules in the Tax Administration Act have been amended to allow non-personal information to be shared under an Approved Information Sharing Agreement (AISA) authorised under Part 9A of the Privacy Act 1993.

Previously, the tax secrecy rules allowed Inland Revenue to disclose personal information about an identifiable individual under an AISA but not non-personal information.

Background

Section 81A of the Tax Administration Act enables Inland Revenue to share personal information when the sharing is authorised under an AISA. However, personal information is often mixed in with non-personal information – for example, information about a company or trust operated by an individual. In these instances the previous wording of the tax secrecy provision did not allow Inland Revenue to fully realise the potential to share taxpayer information under an AISA (which can accommodate the sharing of both personal and non-personal information).

The change will enable non-personal information to be shared under an AISA. This amendment fulfils the intention of the AISA framework, which is to allow all information (personal and non-personal) to be shared for an approved purpose.

Key features

Section 81A has been amended by replacing the words "personal information about an identifiable individual" with "information".

Application date

This amendment came into force on the date of enactment, being 30 March 2017.

Time bar and ancillary taxes and AIL

Section 108(1C), (1D) of the Tax Administration Act 1994

An amendment clarifies that the time bar applies to ancillary taxes and the approved issuer levy (AIL), when a taxpayer has filed a relevant return.

Background

The time bar in section 108 of the Tax Administration Act 1994 prevents the Commissioner from increasing an income tax assessment after four years from the end of the tax year in which a return has been filed and an assessment has been made (subject to certain exceptions).

Under the previous rules, there was some uncertainty about whether the time bar ordinarily applied to ancillary taxes or AIL. Ancillary taxes are defined in section YA 1 of the Income Tax Act 2007, and include some important elements of the New Zealand tax system, including PAYE, fringe benefit tax (FBT), resident withholding tax (RWT), and non-resident withholding tax (NRWT). The approved issuer levy, while not within the definition of an ancillary tax, is similar in many respects to ancillary taxes. The application of the time bar was uncertain because, for it to apply, three requirements had to be satisfied:

- the taxpayer must have furnished an income tax return;
- an assessment must have been made; and
- four years must have passed from the end of the tax year in which the taxpayer provides the tax return.

In some cases, it was unclear whether an income tax return had been filed in the circumstances. For example, an AIL return is filed under the Stamp and Cheque Duties Act 1971 and is not treated as an income tax return. More significantly, in most cases no assessments are made for ancillary taxes. It is only if the Commissioner decides to issue an assessment under one of the discretionary assessment provisions in the Tax Administration Act 1994 that an assessment is made. This meant that, although the Income Tax Act 2007 deems ancillary taxes to be income tax, in practice the time bar did not apply in many cases.

Key features

An amendment clarifies that the time bar applies to an ancillary tax when a taxpayer has filed the relevant return. The filing of the return is treated as the making of an assessment for the purposes of the time bar. The amendment also clarifies that the time bar applies when a taxpayer has filed an AIL statement under section 86K of the Stamp and Cheque Duties Act 1971. The filing of the statement is treated as the making of an assessment of the levy by the taxpayer for the purposes of the time bar.

For the purposes of the time bar only, the amendment also provides that when a taxpayer files an AIL statement they will be treated as having met the requirements for furnishing an NRWT return in relation to the information contained in the relevant return.

The effect of the amendment will be to ensure the time bar applies to ancillary taxes and AIL (including the exceptions to the time bar). This means that the Commissioner will only be able to increase an assessment of an ancillary tax or AIL:

- within four years from the end of the period in which the taxpayer furnishes the relevant return; or
- at any time, if the Commissioner is of the opinion that the return is fraudulent or wilfully misleading, or does not mention income that is of a particular nature or was derived from a particular source (consistent with the existing exceptions in the income tax time bar).

The period in which the taxpayer furnishes the relevant return will depend on the relevant tax or levy. If the return relates to a specified period then the relevant period will be the period in which the return is filed (PAYE, FBT). When the return relates to a specific transaction, the relevant "period" will be the time when the transaction is returned (AIL, NRWT, RWT, retirement savings scheme contribution tax, residential land withholding tax). For those returns that relate to end-of-year balances, the relevant period will be the year the return is filed (further income tax, imputation penalty tax and Māori authority penalty tax).

Examples

Bert filed an NRWT return for $5,000 of interest paid during October 2016 on 20 November 2016. The return contained an accidental error that understated the amount of NRWT that should have been withheld for the period. As the NRWT return was filed on 20 November 2016, the Commissioner cannot increase the amount assessed in the relevant NRWT return after 20 November 2020 (unless one of the exceptions to the time bar applies).

Sarah filed an AIL return for interest of $7,500 paid in November 2016 on 20 December 2016 on the mistaken belief that AIL (and not NRWT) was payable on the interest. The Commissioner subsequently considers that Sarah should have withheld NRWT on the interest. Unless one of the exceptions to the time bar applies, the Commissioner has until 20 December 2020 to amend the relevant assessment to require NRWT to be withheld on the interest payment rather than AIL.

Application date

The amendment commenced on 3 May 2016. This means that the Commissioner cannot increase an amount of an ancillary tax or AIL return after 3 May 2016, if four years have passed from the end of the period in which the taxpayer provided the relevant return (unless one of the existing exceptions applies).

Annual setting of income tax rates

Schedule 1 of the Income Tax Act 2007

The annual income tax rates for the 2016–17 tax year are the rates specified in schedule 1 of the Income Tax Act 2007.

Application date

The rates apply for the 2016–17 tax year.

WORKING FOR FAMILIES TAX CREDITS

Parental tax credit abatement formula

Sections MD 2(3) and (4) of the Income Tax Act 2007

Section MD 2(3) and (4) has been amended to ensure parental tax credit (PTC) recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year have the correct amount of abatement applied to their credit. The amendment also applies to PTC recipients whose Working for Families tax credit (WFFTC) entitlement changes during their entitlement period.

Background

As part of Budget 2014, the Taxation (Parental Tax Credit) Act 2014 introduced a new PTC abatement formula in section MD 2(3). As enacted, the resulting PTC abatement formula was intended to ensure the PTC was abated against each dollar of family scheme income earned above the annual WFFTC income threshold for the entire tax year. Before this, the PTC was only abated against the income earned by a family during their parental entitlement period. This shorter period resulted in an effective abatement rate of around 4% over the year. In contrast, the other WFFTCs are subject to an abatement rate of 22% on family scheme income earned above the income threshold for the tax year. The lower effective abatement rate on PTC meant most parents continued to receive PTC on family incomes over $100,000 a year.

Key features

The amendments made to the PTC abatement formula in section MD 2(3) change "entitlement days" to "70". This ensures that PTC recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year, or whose WFFTC entitlement changes during their parental entitlement period, do not have a greater amount of abatement applied to their credit than the Government intended.

The number of days a recipient is entitled to the PTC within the full 70-day parental entitlement period does not need to be explicitly included in the PTC abatement formula. The adjustment for these days is already accounted for in the calculation of "entitlement period abatement amount" (previously "period abatement amount") and "amount used".

The definition of "entitlement days" has been deleted from section MD 2(4) as this term is longer used in the PTC abatement formula.

Detailed analysis

Officials were concerned the drafting of the PTC abatement formula in section MD 2 and its related provisions in the Income Tax Act 2007 could inadvertently result in a person's PTC entitlement being subject to a greater amount of abatement than intended in specific circumstances. Hence, the amount of PTC some people received could have been reduced below what the Government intended when the PTC Budget 2014 changes were announced. The PTC abatement formula at that time was:

(period abatement amount[20] *– amount used)* × 365 ÷ *entitlement days*

"Entitlement days" was defined as "the number of days in a parental entitlement period that are in the abatement period". If a person was entitled to the full 10 weeks of PTC, this would equate to 70 entitlement days. In this situation the formula worked. It grossed the PTC abatement amount for the 70-day period up to a full year equivalent.

However, if a person was entitled to the PTC for less than 10 weeks, the formula could subject PTC recipients' credit to a larger amount of abatement than the Government intended. A person may only be entitled to the PTC for say, five weeks if they received a welfare benefit for the other five weeks, and their "entitlement days" would be 35.

The number of "entitlement days" would also be lower for PTC recipients who had a parental entitlement period that spanned two tax years (their child was born near the end of the tax year). They could, for instance, have had 35 entitlement days in the first tax year and 35 entitlement days in the second tax year. In this situation the formula in section MD 2 could gross up both 35-day abatement periods to a full year equivalent. Conversely, the PTC calculation formula in section MD 12 reduces a recipient's entitlement to take into account of the number of days they were eligible to receive the payment out of the maximum number of days (70). Therefore, the recipient was only eligible to receive half the PTC for each tax year but was abated against a full year's income. The net result being that PTC recipient's credit was subject to a larger amount of abatement than the Government intended.

[20] The Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 replaces "period abatement amount" with "entitlement period abatement amount" in the PTC abatement formula in section MD 2(3) of the Income Tax Act 2007.

Example[21]

Sarah and Hayden have one child aged 4, and a new baby. Hayden works as an electrician earning $95,000.

Their family tax credit entitlement is $8,173, their in-work tax credit entitlement is $3,120. They also claim the PTC as a lump sum and are eligible for a parental tax credit of $2,200, before abatement, for the year to 31 March 2016.

Family scheme income	$95,000
Less abatement threshold	($36,350)
Abatement rate	× 21.25%
Full year abatement	$12,463.13

First entitlement period = 26 Feb 2016 to 31 March 2016 (35 days/5 weeks)

Family credit abatement for entitlement period = $12,463.13 × 35/365

= $1,195.09

Family tax credit	($8,173 × 35/365)	$783.71
Less abatement		($1,195.09)
		−$411.38
In-work tax credit	($3,120 × 5/52)	$300.00
Less remaining abatement		($411.38)

Before the PTC amount is abated, the remaining credit abatement is scaled up, using the PTC abatement formula in section MD 2(3):

$$\text{Scaled up credit abatement for PTC} = (\text{period abatement amount} - \text{amount used}) \times \frac{365}{\text{entitlement days}}$$

$$= (\$1{,}195.09 - \$783.71 - \$300.00) \times \frac{365}{35}$$

= **$1,161.53**

There is a similar calculation for the period 1 April 2016 to 5 May 2016 (35 days) under section MD 16, resulting in a scaled up abatement of $1,161.53.

Under the old PTC abatement formula:

Abated PTC = $1,100 – $1,161.53 (1st entitlement period) + $1,100 – $1,161.53 (2nd entitlement period)

= **$0** (incorrect abatement applied)

Under the amended PTC abatement formula:

Abated PTC = $1,100 – $580.77 (1st entitlement period) + $1,100 – $580.77 (2nd entitlement period)

= $1,038 (correct abatement applied)

Application date

The amendment applies to dependent children born on or after 1 April 2015, to ensure it applies to all children affected by the Budget 2014 PTC abatement changes.

Parental tax credit entitlement periods

Sections MD 2(3), MD 2(4), MD 12(1) and MD 12(3)(b) of the Income Tax Act 2007

Sections MD 2(3), MD 2(4), MD 12(1) and MD 12(3)(b) have been amended to make it clear that a separate amount of Parental Tax Credit (PTC) and a corresponding amount of abatement apply to each entitlement period within a parental entitlement period.

Background

Determination of a PTC entitlement involves calculating a separate amount of PTC and a corresponding amount of abatement to apply to each entitlement period within a parental entitlement period. The separately abated PTC amounts for a tax year are added together to create the total PTC for a tax year. All the separate Working for Families tax credits (WFFTC) abated amounts for each entitlement period are added together in this way to ensure a WFFTC recipient's end-of-year entitlement reflects changes to their family's circumstances during the year.

[21] This example is based on the example outlined in the *TIB* 2014 No 28: **http://www.ird.govt.nz/technical-tax/legislation/2014/2014-28/2014-28-index.html** and uses the former abatement rate of 21.25% and in-work tax credit rate of $3,120. The abatement rate increased to 22.5% and payment to $3,770 from 1 April 2016.

However, in some of the PTC abatement and entitlement provisions it was not clear that a separate amount of PTC and a corresponding amount of abatement apply to each entitlement period within a parental entitlement period.

In particular, there was concern that the wording in the PTC abatement formula in section MD 2 could produce unintended results. "Period abatement amount" in the PTC abatement formula in section MD 2(3) could be interpreted as being the abatement amount for the whole tax year. But the way the general WFFTC provisions are worded indicated that a new PTC abatement amount is calculated each time a person's WFFTC entitlement changes. Therefore, it could have been argued that section MD 2 calculated a full year PTC abatement amount to apply against the PTC each time a person's WFFTC entitlement changed. This would result in a PTC recipient's credit being subject to a larger amount of abatement than the Government intended.

A similar problem with ambiguity in the PTC legislation regarding the relationship of the parental entitlement period and the entitlement period was identified in the definition of "days" in section MD 12(3)(b).

Key features

The amendments made to the definition of items in the PTC formula in section MD 2(4) and the insertion of these terms into the formula in section MD 2(3) ensures separate PTC amounts are calculated for each entitlement period within the parental entitlement period.

The amendment made to the PTC entitlement provision in section MD 12(1) makes it clear that a separate PTC entitlement is calculated for each entitlement period.

The amendment made to section MD 12(3)(b) changes the definition of "days" in the PTC entitlement formula to make it clear that it refers to the number of days in an entitlement period within a parental entitlement period.

The amendments make it clear that a separate amount of PTC and a corresponding amount of abatement apply to each entitlement period within a parental entitlement period.

Application dates

The amendments to section MD 2(3) and (4) apply for dependent children born on or after 1 April 2015. This ensures the amendments apply to all children affected by the Budget 2014 PTC abatement changes.

The amendments to sections MD 12(1) and MD 12(3)(b) apply on and after 1 April 2008, the date the PTC rule for recipients who have a parental entitlement period that spans two tax years and receive their credit as a lump sum was introduced, as they merely clarify the rule's original policy intent.

Parental tax credit "cross-year" situations

Sections MD 1(3)(c), MD 1(3)(d), MD 12(5), MD 12B and MD 13(4B) of the Income Tax Act 2007

Section MD 1(3)(c) has been amended to clarify that Parental Tax Credits (PTC) recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year may receive their credit as a lump sum in an end-of-year assessment for the first tax year (a cross-year situation).

The amendment to section MD 1(3)(d), and the addition of sections MD 12(5) and MD 13(4B), make it clear when a PTC recipient has a "cross-year situation", an extra amount of PTC abatement is added to the first tax year that relates to one or more entitlement periods in the second tax year that are within the parental entitlement period.

Section MD 12B matches sections MD 12(5) and MD 13(4B), and makes it clear that a corresponding extra amount of PTC is added to the first tax year that relates to the entitlement period that starts in the second tax year.

Background

A PTC "cross-year situation" rule was introduced on 1 April 2008. It was intended to ensure recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year can receive their PTC entitlement as a lump sum in the end-of-year assessment for the first tax year. However, this extra amount was not explicitly provided for in the Working for Families tax credit entitlement provisions. A "cross-year situation" rule was required because when a PTC recipient's parental entitlement period spans two tax years, the family credit abatement provision in section MD 13 could produce unintended results (for example, because the parent takes unpaid leave when the child is born and has reduced income in the second tax year).

It could also be of more use to the recipient to receive the PTC closer to the time of the birth of the child. The PTC abatement formula in section MD 16 was introduced as an alternative way to calculate total abatement for these "cross-year situations". Since 1 April 2014 the PTC abatement is calculated using the general formula for the first tax year and then calculates an extra amount of abatement relating to the recipient's entitlement periods in their parental entitlement period in the second tax year.

The Budget 2014 legislative changes to the PTC abatement provisions did not update the provision in section MD 16, which calculates the additional amount of PTC abatement that is applied in the first tax year if a recipient receives the PTC as a lump sum in the end-of-year assessment for the first tax year. It was not clear whether the PTC abatement formula in section MD 2 applied the full-year abatement to each tax year for people in this "cross-year situation". If this were the case, these recipients' PTC could be subject to a greater amount of abatement than the Government intended.

The amendments clarify, from the relationship between section MD 16 and the other abatement provisions (in sections MD 1(3)(d) and MD 13), that an extra amount of abatement will apply to the first tax year when a PTC recipient has a "cross-year situation". The extra amount relates to the number of days in their parental entitlement period that are in one or more entitlement periods in the second tax year. It is also made clear that as section MD 16 calculates the additional amount of PTC abatement in the second tax year, the other provision (that is, section MD 13) should not also calculate an amount of PTC abatement for the second tax year.

Key features

The amendment made to section MD 1(3)(c) clarifies the definition of "Parental Tax Credit" to make it clear if a PTC recipient receives their credit as a lump sum in the first tax year, an extra amount of credit will be added to the last entitlement period in the first tax year to account for the days in the second tax year.

The amendment to section MD 1(3)(d) amends the definition of "credit abatement" to clarify when a PTC recipient has a "cross-year situation", an extra amount of abatement is added to the last entitlement period in the first tax year that relates to one or more entitlement periods that starts in the second tax year.

Sections MD 12(5) and MD 13(4B) clarify that the extra amount of credit or abatement, as applicable, to apply to the first tax year when a PTC recipient has a "cross-year situation" relates to the number of days in their parental entitlement period in the second tax year. It also outlines that this is calculated under sections MD 12B or MD 16, not sections MD 12 or MD 13. As a result, sections MD 12(5) and MD 13(4B) ensure that there is no "double counting" of credit or abatement amounts that relate to parental entitlement days in the second tax year in cross-year situations.

Section MD 12B operates the same way as section MD 16, but it calculates an additional amount of PTC, rather than an additional amount of PTC abatement.

Application dates

The amendment to section MD 1(3)(c) applies on and after 1 April 2008, the date the "cross-year situation" rule for recipients that have a parental entitlement period that spans two years and receive their credit as a lump sum was introduced.

The amendment to section MD 1(3)(d) applies for dependent children born on or after 1 April 2015, to ensure it applies to all children affected by the Budget 2014 PTC abatement changes.

New subsection (5) in section MD 12 and new section MD 12B apply on and after 1 April 2008, the date the PTC rule for people in "cross-year situations" was introduced, as they merely clarify the rule's original policy intent. The parts of these provisions that refer to "56 days" are changed to "70 days"; apply for dependent children born on or after 1 April 2015. This is to reflect the Budget 2014 extension of the maximum parental entitlement period.

New subsection (4B) in section MD 13 applies on and after 1 April 2014 as this provision refers to the formula used in section MD 16. This formula was changed on this date to clarify that an extra amount of PTC abatement calculated which relates to the recipient's entitlement days in the second tax year is added on to the PTC abatement calculated for the first tax year in "cross-year situations". Due to the Budget 2014 changes, the part of the provision that says "56 days" is changed to "70 days"; applies for dependent children born on or after 1 April 2015.

Minor parental tax credit clarifications

Sections MD 2(3), MD 11(6)(a) and (b), MD 12, MD 12B, MD 13(4) and MD 16 of the Income Tax Act 2007

The amendment to section MD 2(3) replaces sections MD 1 and MD 16 with sections MD 1(3)(d)(i) and MD 16(3)(a), to make it clear when the Parent Tax Credit (PTC) abatement formula should be used.

The amendments to section MD 11(6)(a) and (b) make it clear when the PTC is paid out as a lump sum in an end-of-year assessment, and when the PTC is paid out as instalment payments during the year.

The amendment to section MD 13(4) changes the section heading to make it clearer what happens when the parental entitlement period crosses two tax years.

The amendment to section MD 16 changes the section heading to make it clearer that the additional PTC abatement is to apply in the tax year of birth if the parental entitlement period crosses two tax years and the credit is paid as a lump sum.

The amendments to sections MD 12, MD 12B, MD 13 and MD 16 which refer to "56 days" have been changed to "70 days" in line with the Budget 2014 extension of the maximum parental entitlement period from 56 to 70 days.

Application dates

The amendment to section MD 2(3) applies for dependent children born on or after 1 April 2015. This ensures the amendment applies to all children affected by Budget 2014 changes to the PTC abatement formula in section MD 2.

The amendments to section MD 11(6)(a) and (b) came into force on 30 March 2017 (being the date of enactment), as they are minor clarifications.

The amendments to sections MD 13(4) and MD 16 apply on and after 1 April 2014, as this is the date relevant changes were made to the formula in section MD 16, which is referred to in section MD 13.

The amendments in section MD 12, MD 12B, MD 13 and MD 16 that refer to "56 days" being changed to "70 days" apply for dependent children born on or after 1 April 2015.

Fringe benefit vouchers and social policy income

Section MB 7B of the Income Tax Act 2007 and schedule 3 of the Student Loan Scheme Act 2011

Section MB 7B of the Income Tax Act 2007 and clause 12A of schedule 3 of the Student Loan Scheme Act 2011 have been amended to enable employees, for social policy purposes, to apply the maximum fringe benefit tax (FBT) rate on their short-term charge facilities provided by their employer, if the employer does not provide the correct rate.

Background

From 1 April 2014, employees have been required to include short-term charge facilities (such as vouchers) from their employer in their family scheme income (used to determine Working for Families tax credits, community services card and student allowance entitlements) and in their adjusted net income (used to determine student loan repayments). This requirement was intended to improve the fairness and integrity of the schemes as short-term charge facilities are equivalent to cash wages. Included in the calculation of the value of an employee's short-term charge facility is the amount (if any) of FBT paid by their employer. However, social policy recipients and student loan borrowers were unable to include the correct amount of FBT in their family scheme income or net adjusted income if the employer refused or was unable to provide them with this information. This made completing the application forms difficult.

Key features

Section MB 7B(3) enables employees to use either the rate of FBT used by their employer or the maximum rate of FBT to calculate the FBT payable on their short-term charge facilities. This enables employees, when calculating their income for Working for Families tax credits, community services card and student allowance purposes, to apply the maximum FBT rate on their short-term charge facilities (such as vouchers) provided by their employer, if the employer does not provide the correct rate.

The amendments made to schedule 3 of the Student Loan Scheme Act 2011 enable a person to use the FBT rate used by their employer or the maximum FBT rate to calculate the amount of FBT on a short-term charge facility. This enables employees, when calculating their income for student loan repayment purposes, to apply the maximum FBT rate on their short-term charge facilities provided by their employer, if the employer does not provide the correct rate.

Application date

The amendments apply on and after 1 April 2014, the date from which employees have been required to include short-term charge facilities in their income for social policy purposes.

OTHER REMEDIAL AMENDMENTS

Tax pooling provisions

Sections 190, 196, 229, 234

These amendments ensure that the tax pooling rules work as intended. The amendments allow an imputation credit date when purchased tax pooling funds are used to meet an increased amount of tax that is not income tax. The amendments also prevent the double counting of an imputation debit when new shareholders of the company or group sell the company's or group's own deposited tax pooling funds to another pool user.

The amendments are relevant for standard ICA companies and for consolidated groups.

Background

Imputation credit accounts (ICA) record the amounts of tax paid by the company on its income and the allocation of this tax to shareholders. Tax payments and their allocation to shareholders by the companies must have credit and debit dates.

ICA companies commonly purchase funds from tax pools. With effect from 6 October 2009, earlier changes to tax pooling rules were made to allow tax pooling to be used for some payments of tax other than income tax. Subsequently, two drafting errors have been identified:

- the omission of a credit date when an ICA company uses purchased pooling funds to meet a non-income tax obligation that resulted from an increased amount of tax; and
- double counting of debits in the ICA relating to the sale of tax pooling funds after a breach of shareholder continuity.

Key features

The amendments provide for a credit date where purchased tax pooling funds are used to meet an increased amount of tax that is not income tax, with the credit date being the date of the transfer, by amending sections OB 6(3) and OP 9(3) of the Income Tax Act 2007. Due to a previous drafting error, there was no legislative provision which would provide a credit date in this situation.

The amendments also provide for the elimination of the second debit when new shareholders of the company or group sell the tax pooling funds to another pool user by amending sections OB 26(2), (4) and OP 23(4)(a) of the Income Tax Act 2007. This debit in turn follows the previous debit in the ICA when there was a breach of the shareholder continuity and subsequent cancellation of imputation credits from pooling funds. Previously, if the shareholders of the company or group sell the tax pooling funds to another pool user, it would result in a second ICA debit in relation to the same deposit amount.

Application dates

The application date for the amendments relating to an imputation credit date where purchased tax pooling funds are used, is 6 October 2009. For amendments that provide for the elimination of an imputation debit when new shareholders of the company or group sell the company's or group's own deposited tax pooling funds to another pool user, the application date is 1 April 2008.

Detailed analysis

No credit date when pooling funds purchased to meet a non-income tax obligation

Because the imputation rules require all funds that go through a tax pooling account to flow a corresponding credit (and where necessary a debit) through the company's ICA (subpart OA), this means all use of tax pooling funds for non-income tax obligations also flow through the ICA by way of reciprocal credits and debits with appropriate dates.

However, when the 2009 changes to tax pooling were made, a drafting omission resulted in no credit date being able to be determined in relation to the funds that go through a tax pooling account in the situation where an ICA company uses purchased pooling funds to meet a non-income tax obligation that resulted from an increased amount of tax (section OB 6(3) and section OP 9(3) for consolidated groups of companies). There were no issues with debit dates.

When the money has been purchased from a tax pool in accordance with section OB 6(3) or section OP 9(3), as applicable, the purchaser of the funds may then want to:

a) use the purchased funds to satisfy an income tax liability;

b) request for the purchased funds to be refunded;

c) on-sell the purchased funds to another person;

d) use the purchased funds to satisfy a non-income tax liability.

Although section OB 6(3) and section OP 9(3), as applicable, provide credit dates for situations "a" to "c", no legislative provision gave a credit date for situation "d".

The solution was to amend section OB 6(3) and for consolidated groups section OP 9(3) of the Income Tax Act 2007 to provide for a credit date where purchased tax pooling funds are used to meet an increased amount of tax that is not income tax with the credit date being the date of the transfer.

Double counting of debits in the ICA

If there is a breach of shareholder continuity, pre-breach imputation credits from the taxpayer's own deposited pooling funds in the company's ICA get cancelled. This results in a debit arising in the ICA (section OB 41 and for consolidated groups section OP 42).

If the new shareholders of the company or group, as applicable, sell the tax pooling funds to another pool user it results in the second ICA debit in relation to the same deposit amount (section OB 35 or section OP 33, as applicable).

Previously, in the Income Tax Act 2004, this was relieved by the provision of an imputation credit arising, which eliminated the second debit. However, following the rewrite this relief was inadvertently omitted.

The latest amendment hence corrected sections OB 26(2)(a) and (4)(a) and OP 23(2)(a) and (4)(a) of the Income Tax Act 2007 to ensure that such relief is now provided.

Taxable bonus issues and available subscribed capital

Section CD 43(7) of the Income Tax Act 2007

The amendment to section CD 43(7) of the Income Tax Act 2007 clarifies that imputation credits attached to a taxable bonus issue are not included in available subscribed capital (ASC).

Background

A company can allocate additional shares to its shareholders as bonus issues. These may be taxed as if they were dividends and imputation credits can be attached. Imputation credits are a tax credit against the shareholder's tax liability for the dividend and are not equivalent to capital invested in the company.

When a company makes a taxable bonus issue, the amount of the issue is included in the company's ASC amount, which may be returned tax-free to shareholders upon liquidation of the company.

In the ASC rules, section CD 43(6)(b) states that the subscriptions amount includes, in the case of a taxable bonus issue that is not a bonus issue in lieu or a share issued under a profit distribution plan, the amount of the dividend arising from a taxable bonus issue. Section CD 15(1)(a) states that the amount of a dividend is increased by an imputation credit attached to the dividend. The result is that the word "dividend" in the ASC rules can be read to include imputation credits.

This was not intended. Imputation credits are a tax credit against the shareholder's tax liability for the dividend and are not equivalent to capital invested in the company. The result was that the ASC may be overstated. This also resulted in an unequal treatment between taxable bonus issues and ordinary cash dividends, which are reinvested, although in economic terms there is no difference between the two methods of increasing the share investment.

The amendment to section CD 43(7) clarifies these issues.

Application date

The amendment came into force on the date of the enactment, being 30 March 2017.

Exceptions to the requirement to use the same calculation method for the same FIF

Section EX 46 of the Income Tax Act 2007

The amendment resolves uncertainty over which calculation method should be applied when a person holds more than one interest in the same foreign investment fund (FIF). This uncertainty arose from:

- the requirement to use the same method for multiple interests;
- and the separate requirement to use a specific method for one of the interests.

Background

Before this amendment, the Income Tax Act 2007 provided several methods for calculating a person's FIF income. There was some uncertainty about which method should be applied when a person holds more than one interest in the same FIF.

For example, when a taxpayer had two interests in one FIF that are of different classes – one being ordinary shares and the other fixed rate shares – under section EX 46, the taxpayer was *prima facie* required to use the same calculation method for each interest.

However, section EX 47 limits the calculation methods available for fixed-rate shares and generally requires the comparative value method to be used. Therefore in this case it was arguable that the taxpayer must apply the same method to the ordinary shares as well. The policy intent is that the taxpayer should be allowed to choose a different method for the ordinary shares.

Key features

The uncertainty was a result of a conflict between section EX 46 and sections EX 47, EX 48 and EX 62. Section EX 46 requires the use of the same calculation method for multiple interests in the same FIF (when the interests are of the same class), while sections EX 47, EX 48 and EX 62 require the use of a specific method for one of the interests.

Under section EX 44, a taxpayer has a choice between various methods when calculating FIF income or losses from their FIF interests, subject to certain limitations.

If a taxpayer had two or more attributing interests in the same FIF for the same period, they were required to use the same calculation method for each interest (section EX 46(1)). A taxpayer can also use a different calculation method for each interest if the interests are of different classes (for example, fixed-rate shares and ordinary shares), and if section EX 46 prevents the same method being used.

However, there are other sections that limit the choice of calculation methods, which are not contained within section EX 46 (namely, requirements imposed by sections EX 47, EX 48 and EX 62). This resulted in a potential conflict between the requirement to use the same method for multiple interests in section EX 46(1) and a requirement to use a specific method for one of the interests (due to any of the sections EX 47, EX 48 and EX 62).

The amendment to section EX 46 clarifies the intended policy on exceptions to the requirement to use the same calculation method for multiple interests in the same FIF. The amendment clarifies that a different calculation method is allowed for interests in the same FIF when a particular provision requires a specific method to be used.

Application date

The amendment came into force on the date of the enactment, being 30 March 2017.

Rationalisation of foreign tax credits provisions

Sections LJ 1(4), (5), LJ 3 and YA 1 of the Income Tax Act 2007

The provisions amend or repeal a number of provisions in subpart LJ, and also amend section YA 1 of the Income Tax Act 2007, to rationalise the foreign tax credit provisions.

Background

Foreign tax credits prevent the double taxation of foreign-sourced income derived by a New Zealand-resident taxpayer by providing a credit for foreign tax paid on that income. Foreign tax credits can be credited against the relevant New Zealand income tax.

Foreign tax credits can be bilateral (arising under a double tax agreement), or unilateral (arising under New Zealand's domestic provisions). The rules for bilateral foreign tax credits were enacted in 1960, and the rules for unilateral foreign tax credits were enacted in 1962. In legislation preceding the Income Tax Act 2007, the provisions governing foreign tax credits primarily referred to credits allowed under double tax agreements (DTAs). As part of the rewrite of the foreign tax credit provisions and other amendments, the references to DTAs have been largely removed. The new amendments further rationalise the foreign tax credit provisions in light of the general removal of DTA references. These amendments do not affect entitlements to foreign tax credits.

Key features

The following provisions have been repealed or amended:

Section LJ 1(5)

Section LJ 1(5) has been repealed. Before its repeal, the provision provided that subpart LJ, for the purposes of section LJ 2 (the provision under which foreign tax credits are allowed), applied as if section LJ 1(5) were a DTA.

Section LJ 1(5) and its forerunners were a mechanism for making the original unilateral foreign tax credit provision subject to the rules in the foreign tax credit provisions that referred to DTAs. Because provisions regulating tax credits no longer refer to DTAs, section LJ 1(5) was unnecessary and potentially confusing.

The definition of "foreign tax" in section YA 1

The definition of "foreign tax" in section YA 1 has been repealed. The definition applied for subpart LJ purposes but it was only used in section LJ 1(4). The rest of subpart LJ refers to the definition of "foreign income tax" in section LJ 3. The definition of "foreign tax" used to be widely used in earlier versions of the foreign tax credit provisions. As part of the rewriting of the foreign tax credit provisions, all references to "foreign tax" in subpart LJ have been removed (except in section LJ 1(4)). Removing the "foreign tax" definition has rationalised the definitions applying for foreign tax credit purposes.

As part of rationalising the foreign tax credit rules, the reference to "foreign tax" has also been removed in section LJ 1(4).

Section LJ 1(4)

Section LJ 1(4) attributes a foreign source to dividends paid by non-resident companies for foreign tax credit purposes. This provision ensures that a credit for foreign withholding tax paid on a dividend derived by a New Zealand resident from a non-resident company that is listed on the New Zealand Stock Exchange is still available. Without this specific provision there is a risk that the dividend could be regarded as being sourced in New Zealand. A New Zealand resident is only allowed a credit under section LJ 1(2)(a) for foreign tax paid on income sourced from outside New Zealand.

Previously, section LJ 1(4) was restricted to dividends paid by a company resident in a country with which New Zealand has a DTA.

The scope of section LJ 1(4) was amended to remove its DTA references so it now applies to dividends paid by all non-resident companies.

Section LJ 3

The definition of "foreign income tax" in section LJ 3 has been clarified. Before this amendment, "foreign income tax" had been defined in section LJ 3 as meaning "an amount of income tax of a foreign country or territory". There was no clear link between the definition of "foreign income tax" and either a tax that gives rise to a foreign tax credit under a DTA or the definition in section YA 2(5) of income tax imposed by other countries. The definition of "foreign income tax" in section LJ 3 has been amended so that it now refers to both foreign taxes under a DTA as well as the definition of "income tax" in section YA 2(5). This means that the definition of "foreign income tax" in section LJ 3 clearly applies to both unilateral and bilateral foreign tax credits.

Application date

The provisions apply from the date of enactment, being 30 March 2017.

Repeal of redundant foreign dividend payment provisions

Sections CD 15 to CD 17, CD 40, CD 43, CD 53, CX 63, FM 6, FM 7, FM 27 to FM 30, GB 35, GB 36, GB 41, HA 18, HA 19, HA 41, HG 2, HM 19, HM 70, HM 76, IA 3, LA 6, LE 1, LE 6, LE 8, LE 9, subpart LF, LJ 8, LP 5, OA 2, OA 5 to OA 8, OA 10, OA 11, OA 15, OA 16, OA 18, OB 4, OB 10, OB 12, OB 24, OB 36 to OB 38, OB 43, OB 45, OB 53, OB 60, OB 76, OB 81, OB 82, table O1, table O2, subpart OC, table O4, OK 1, OK 7, OK 14, OK 14B, table O17, table O18, OP 5, OP 7, OP 13, OP 18, OP 19, OP 34 to OP 36, OP 45, OP 51 to OP 74, table O19, table O20, cross-headings between table O20 and OP 75, OP 75 to OP 77, table O21, table O22, OZ 3, OZ 7B, OZ 8 to OZ 12, RA 19, RE 2, RE 13 to RE 15, RE 17, RE 23, RF 8 to RF 10, RE 14, RM 3, YA 1, YA 2, YC 12, YC 17, YC 18, schedule 1 of the Income Tax Act 2007

Sections 22, 24K, 29, 30, 30C, 43A, 68, 71, cross-headings before 71B, 71B, 72, 73, 78D, 90AF, 113B, 125, 140B, 166, 180, 185 of the Tax Administration Act 1994

The provisions amend or repeal a large number of redundant foreign dividend payment (FDP) provisions from the Income Tax Act 2007 and Tax Administration Act 1994 that still referred, or related, to FDP. FDP was charged on foreign dividends derived by a New Zealand resident company, but ceased to be charged for income years beginning on or after 1 July 2009. The FDP charging provisions in subpart RG were repealed as part of the wider changes to the international tax rules in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

On 1 July 2009, the Government announced that companies' existing FDP credit balances could be carried forward and used for five years. As this period ended on 1 July 2014, the remaining FDP references in tax legislation have been repealed.

Application date

The amendments came into force on 1 April 2017.

Consequential repeals resulting from amalgamation of information sharing provisions

Sections 80KH, 80KK, 81(4), 82, 82A, 83, 84, 85, 85G and 87 of the Tax Administration Act 1994, section 207 of the Student Loan Scheme Act 2011, section 240 of the Child Support Act 1991, and schedule 3 of the Privacy Act 1993

Provisions enabling Inland Revenue to share information with the Ministry of Social Development to help with the administration of benefit, student loan and child support entitlements and obligations under the Tax Administration Act, Student Loan Scheme Act, and the Child Support Act, are to be repealed with effect from a date to be determined by Order in Council.

These information sharing provisions will be amalgamated under one Approved Information Sharing Agreement (AISA) under Part 9A of the Privacy Act 1993.

Repealing the current legislative provisions will ensure that there is no overlap between legislation and regulations.

Background

There are a number of legislative provisions under three Acts (the Tax Administration Act 1994, the Student Loan Scheme Act 2011 and the Child Support Act 1991) which allow the sharing of certain information between Inland Revenue and the Ministry of Social Development. These provisions only enable sharing and use of the information for narrowly defined purposes, are time consuming to amend and require multiple requests for the same information in order assess entitlements to benefits and services. These provisions are considered too inflexible to respond to the needs of government and customer requirements in the future. The Government is amalgamating the current information sharing provisions between the two departments into one Approved Information Sharing Agreement (AISA) under the Privacy Act 1993. This agreement will allow both agencies to share the information they need to determine entitlements to benefits and subsidies and for assessing tax obligations.

The AISA will come into force by way of Order in Council, which is expected to occur in mid-2017. When the AISA is enacted, there will be an overlap between the current legislative provisions and the AISA agreement. The current legislation will be the authorising legislation for information sharing, not the AISA itself, which would make the AISA inoperable. These changes repeal the current legislative provisions with effect from a future date to be determined by Order in Council. The date specified in the Order in Council will be the date the AISA comes into force, once that date is known.

Key features

- Sections 82A, 83, 84, and 85G of the Tax Administration Act are repealed upon the coming into force of the described AISA.
- Sections 82 and 87 of the Tax Administration Act are amended to repeal the parts of those sections that relate to information sharing with the Ministry of Social Development.
- Section 207 of the Student Loan Scheme Act and section 240 of the Child Support Act are amended to repeal the parts of those sections that relate to information sharing with the Ministry of Social Development.
- A number of consequential amendments are made to sections 80KH and 80KK of the Tax Administration Act and Schedule 3 of the Privacy Act 1993 to give effect to these changes.

Application date

These legislative provisions are repealed with effect from a future date to be determined by Order in Council. This date will align with the date the AISA comes into force.

Remedial changes to the taxation rules for insurance business

Sections DB 7, DB 23, EY 2 to EY 3, EY 16B, EY 17, EY 19B, EY 21, EY 23, EY 25, EY 28 and EY 29, OA 5 to OA 7, OA 10, OA 13 to OA 15, OA 17, OB 24, OP 75 and YA 1 of the Income Tax Act 2007

A range of technical and remedial changes have been made to the taxation rules for insurance business contained in the Income Tax Act 2007.

Background

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 made significant changes to the way the Income Tax Act 2007 applies to life insurance business in New Zealand.

The Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 included a range of technical and remedial changes to ensure that the 2009 reform works as intended. The changes therefore confirm or clarify existing policy settings.

Key features

Interest deductibility when life insurer receives exempt income

Section DB 7 has been amended to ensure that groups of companies that include a life insurer, including the life insurer itself, can deduct interest expenses notwithstanding that the life insurer in that income year may have received tax-exempt income (section CW 59C) from a life reinsurance treaty with a non-resident life insurer. The change applies from 1 July 2009 (or earlier income years that include 1 July 2009).

Cost of revenue account property

The scope of section DB 23(2) to life insurers has been clarified so that a deduction is denied only for expenses allocated to the policyholder base in respect of excluded income derived from the proceeds from the sale of investments held by a portfolio investment entity (section CX 55). The change recognises that expenses that have a nexus with revenue account property and allocated to the shareholder base are shareholder base allowable deductions for the purposes of section EY 3. The change has effect for income years that include 1 July 2010 and later income years.

Fees for managing policyholder investments

Changes to sections EY 2(2), EY 3(1), EY 16B and EY 19B set out the tax treatment of certain intra-entity transactions between a life insurer's policyholder base and shareholder base. The rules apply to amounts credited to the shareholder base as consideration for services provided to policyholders in administering and managing funds intended for use in meeting future policyholder claims. The rules apply to life insurance policies that are "savings product policies" and not "profit participation policies" as defined in section YA 1.

Amounts credited to the shareholder base are typically sourced from premiums and supported by a contractual relationship between the life insurer and the policyholder (as documented in the life insurance policy).

New section EY 16B provides a deduction to the policyholder base in an income year equal to the amount credited by the life insurer to the shareholder base.

New section EY 19B creates income for the shareholder base in an income year equal to the amount debited by the life insurer against the policyholder base.

Both new sections EY 16B and EY 19B provide for no double counting of income and deductions otherwise recognised under sections EY 16 and EY 19 respectively.

Changes have also been made to sections EY 2(2)(ab) and EY 3(1)(ab) to recognise these internal transfers within the scheme of the life insurance tax rules.

The new rules apply for income years beginning on and after 1 April 2015. Earlier tax positions taken before Royal assent and based on the new sections had they applied at the time the tax positions are taken, are validated.

Policyholder excess deductions

Section EY 2 sets out the rules for calculating schedular policyholder base income. Under this section, excess deductions are carried forward to the next income year. The carry forward of these excess deductions is not subject to continuity requirements. Two changes have been made to clarify the treatment of excess deductions when there is a transfer of life business and the order in which the excess deductions can be used:

- *Transfers of policies with excess policyholder base deductions* – In response to submissions on the bill, section EY 2 has been amended to provide certainty about the treatment of excess policyholder base deductions in situations when life business is transferred from one life insurer to another. New section EY 2(5B) sets out the necessary adjustments the transferor and the transferee need to make to policyholder allowable deductions affected by a transfer of life insurance business. New section EY 2(5B) applies to transfers occurring on and after the start of the 2016–17 income year. Consequential changes to section EY 2(3) and (4) apply for the 2016–17 and later income years.
- *Ordering rule* – Sections EY 2(3) and (5) have been rewritten and require that excess deductions that are unused in the current income year are carried forward and are treated as policyholder deductions for the next income year. The change clarifies that the deductions that make up the excess must be used in order in which the amount was incurred. Section EY 2(3) applies for the 2016–17 and later income years to support section EY 2(5B) in respect of excess policyholder base allowable deductions affected by a transfer of life insurance policies. Section EY 2(5) has effect from income years starting after the date of Royal assent.

Discounting future amounts

The life insurance rules require life insurers to discount future amounts, and when appropriate, use figures that are net of income tax. References to future amounts have been updated in sections EY 17(2), EY 21(2), EY 28(6) and EY 29(8) so that future values are consistent with the values used by the life insurer in its financial statements. The change means that calculations of future value need not be referenced to a risk-free rate as previously required. The change responds to concerns that the requirement to use a risk-free rate was not always appropriate and could over-allocate income to the policyholder base.

Life reinsurance premiums and claims should be calculated using amounts that are taken into account for the current year.

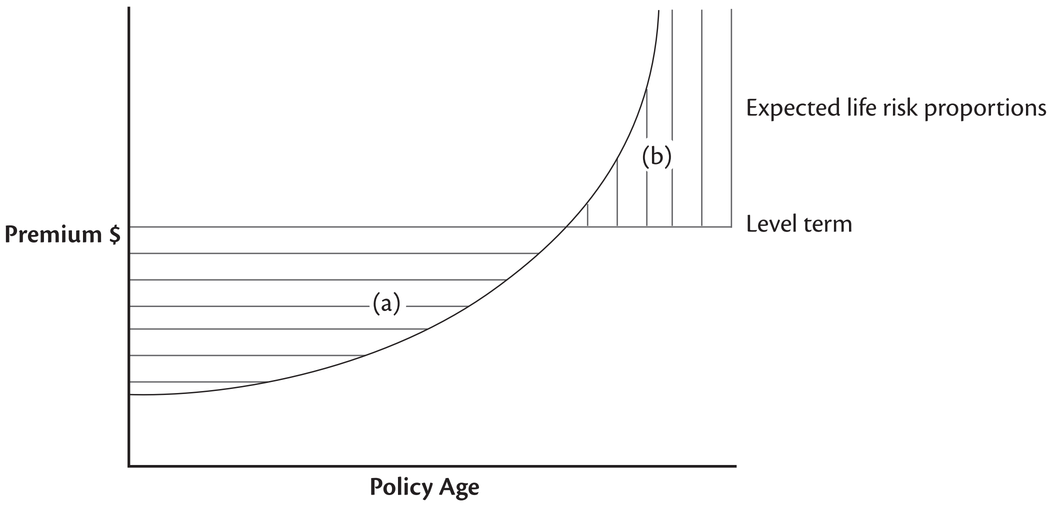
The changes have effect for income years starting on and after Royal assent. Earlier tax positions taken before Royal assent and based on the amendments had they applied at the time the tax positions are taken, are validated.

Premium smoothing reserve

A number of technical clarifications have been made to the rules supporting calculation of amounts under the premium smoothing reserve (PSR). The changes mainly rewrite the main concepts of the PSR to improve reader comprehension. The purpose of the PSR is to allow life insurers to smooth the recognition of premium income against life risk when a life insurance policy is sold on the basis of a single or level-term premium.

- The meaning of "PSR period" in section EY 23(6) is amended to make it clear that the reserve has application when there is a material mismatch in the timing of life risk and the timing of life risk components of premiums. The redrafted section requires the PSR period for a life insurance policy (not being a profit participation policy):
  - to be longer than a year;
  - the premium income received from the life policy may be applicable to the current income year or another income year; and
  - either:
    a) the life risk component of premiums are level or substantially level; or
    b) there is a material mismatch over the PSR period between the timing of life risk and the timing of the life risk component(s) of premium(s).
- The principles used to calculate the reserving amount for the premiums smoothing reserve in section EY 25(3) have been redrafted to make it clear the reserve does not include amounts for policies for which the life insurer's obligations to the policyholder have ceased. The drafting of the section is also revised to be consistent with the definition of "PSR period". The principles are that:
  - For an income year the total of the reserving amount and the life risk component of premiums must equal the expected life risk proportion – this means:
    a) in the early years of the life policy when the reserving amount is negative this results in a shareholder base allowable deduction (see diagram 1), and
    b) in later years of the life policy when the reserving amount is positive, the shareholder base has income.

Diagram 1: Pemium smoothing reserve



(a) Negative PSR adjustment
(a) Positive PSR adjustment

- Over the PSR period for a life insurance policy that runs its full or level term, the sum of the reserving amounts and the life risk component of premiums must equal the total life risk component of premiums, as illustrated below:

  (a +b) – c = 0

  Where:

  a) the sum of reserve amounts, and

  b) life risk premium component for each income year

  c) the total life risk components of premiums for that life insurance policy.

- The PSR does not include amounts for which all obligations have ceased on death, discontinuance or sale. In each case, the PSR should be adjusted for that life insurance policy and the corresponding profit or loss to the life insurer shareholder tax base is recognised in the income year.

- A retrospective grammatical change has been made to section EY 25(3) by replacing the ":" [colon] with an "and" to clarify that the principles used to calculate a reserving amount for the PSR are conjunctive. The change has effect from the income year that includes 1 July 2010 and later income years to the first income year beginning after the day of Royal assent.
- The definition of "expected life risk proportion" in section EY 25(6) has been consequentially amended as a result of the redrafted definition of "PSR period" in section EY 23(6). Each income year should therefore contain the relevant expected life risk proportion (life risk and life risk renewals expenses). This value should equal the life risk component of premiums adjusted for the PSR reserving amount (based on the total amounts described in section EY 25(3)).
- Further changes have been made to section EY 23(1), (2) and (4) to ensure that the reserving rules generally apply to a class of policies that are not "profit participation policies" as defined in section YA 1.

Apart from the retrospective grammatical change in section EY 25(3), the changes to the rules for the Premium Smoothing Reserve apply from the first income year beginning after Royal assent.

Shareholder base income "Other profit" definition of "closing liabilities"

The definitions of "closing policy liabilities" and "estimated closing policy liabilities" in sections EY 28(5) and (6) and EY 29(6) and (8) have been rewritten to improve readability and update the treatment of discounted values for life reinsurance premiums and claims. The changes apply from the first income year beginning after the day of Royal assent. Earlier tax positions taken before enactment and based on the amendments had they applied at the time the tax position was taken, are validated.

Definition of "asset base" and "profit participation policy"

The definition of "profit participation policy" in section YA 1 has been rewritten to clarify that the rules relating to such life insurance policies apply when policyholders and the life insurer (the shareholder base) are eligible to share in the life insurer's profits from such business. The amendment clarifies that life insurance policies allowing policyholders to earn an investment return (as opposed to participating in the life insurer's profit) are not subject to sections EY 17, EY 18, EY 28 and EY 29.

The definition of "asset base" in section YA 1 has also been amended to ensure consistency with the revised definition of "profit participation policy".

The changes apply for the income year that includes 1 July 2010 and later income years.

Removal of redundant terms "Policyholder Credit Account" and "PCA" from the Income Tax Act

A number of sections in the Income Tax Act 2007 have been repealed or amended to remove redundant references to "Policyholder Credit Account" and "PCA". These terms are not used in the life insurance taxation rules since it was substantially changed in 2009. These terms affect the sections FM 30, OA 5 to OA 7, OA 10, OA 13 to OA 15, OA 17, OB 24 and OP 75, the changes have effect from the date of Royal assent.

Application dates

A variety of application dates apply and are specified above.

Recharacterisation of shareholder's base company repurchasing shares

Section FA 4(2)(b) of the Income Tax Act 2007

A share repurchase occurs when a company purchases (repurchases) its own shares from current shareholders. Monies paid to a shareholder under a share repurchase may be taxed as a dividend under the Income Tax Act.

The rewrite of the Income Tax Act changed the amount of an adjustment to the cost price of remaining shares for revenue account taxpayers. Before the rewrite, revenue account taxpayers added the initial cost of the repurchased shares to the remaining shares of the same class. The rewrite changed this rule with the effect that consideration received for the repurchase was added to the value of the remaining shares. Section FA 4(2)(b) has now been restored to its original wording as it was before the rewrite.

The reference to "amount" in section FA 4(2)(b) has been replaced with the phrase "the cost to the shareholder of the cancelled share". The effect of the change means that taxpayers need to add the initial cost of the repurchased shares to the remaining shares of the same class.

The change applies from the 2008–09 and later income years. Earlier tax positions that relied on the law as it then stood for income years and transactions in a return of income filed before the date the bill was introduced on 3 May 2016 are preserved.

Taxable bonus issues – cost base

Section ED 1(4B) of the Income Tax Act 2007

A remedial change to section ED 1 of the Income Tax Act now provides taxpayers with a cost base for taxable bonus issues.

Section ED 1 of the Income Tax Act has been amended by inserting a new rule (section ED 1(4B)) that recognises on disposal of shares received from taxable bonus issues, a cost for those shares. The recognised cost is equal to the amount of the dividend (taxable bonus issue), not including the amount of any imputation credits or withholding tax that applies to the taxable bonus issue.

The amendment applies for shares received under taxable bonus issues made on or after the date of enactment, being 30 March 2017.

Reduction of further income tax: double counting of debit balance

Section OB 67(2) of the Income Tax Act 2007

The amendment corrects a drafting error in section OB 67(2) arising in rewriting the Income Tax Act. The amendment ensures that, when a debit balance of an imputation credit account (ICA) of an ICA company is carried forward from one year to the next, that carried forward debit balance is not again subject to further income tax.

Background

Further income tax is imposed on an ICA company if its ICA has fallen into deficit (a debit balance) during a tax year, and that deficit is not corrected by 31 March of that tax year. Further income tax is imposed to clear that debit balance. This rule ensures that imputation credits are not over-distributed to shareholders during a tax year.

Before the amendment, it was possible for a debit balance carried forward from one year to the next to be subject to a second imposition of further income tax. The policy intent is for further income tax to be imposed only on the net increase in the debit balance of the imputation credit account.

The amendment clarifies section OB 67(2) to ensure that the law works as intended.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Basic tax rate when changing balance dates

Section 39 of the Tax Administration Act 1994

The amendment ensures that a taxpayer is taxed at the correct basic rate for the tax year that corresponds to the income year in which the taxpayer changes their balance date for income tax purposes.

Key features

The amendments to section 39 of the Tax Administration Act 1994:

- clarify the amount of income that is to be grossed up (section 39(5), (7)(a));
- clarify how the grossing up applies in a leap year (section 39(7)(b));
- align the law with existing practice; and
- correct and clarify terminology relating to the use of the term year.

Application date

The amendments came into force on the date of enactment, being 30 March 2017.

Detailed analysis

After a person receives the Commissioner's approval for a change of balance date for a business activity for an income year (the transition year), that person is required to calculate an average tax rate. Section 39 treats that average tax rate as the basic tax rate for calculating the person's income tax liability for the transition year.

The calculation of this average tax rate is based on an annualised amount of business taxable income plus other income, such as wages. This annualisation is necessary because a transition year will either be shorter or longer than a 12-month period.

In the absence of section 39 of the Tax Administration Act 1994, for a transition year a taxpayer would be required to assess their income tax liability for the transition year using the bands of marginal tax rates in schedule 1 of the Income Tax Act 2007. Consequently, the person would potentially be:

- undertaxed if the transition year is shorter than 12 months; or
- overtaxed if the transition year is longer than 12 months.

Prior to this amendment, the existing law did not clearly identify which income should be included in calculating this average tax rate.

Section 39(5), (6), (7)

The amendments in section 39(5), (6) and (7) clarify the type of income to which the formula in section 39(6) applies and ensure that a person is taxed appropriately in a transition year.

In particular, these amendments require a person to determine:

- the amount of income from activities (net of allowable deductions, if any) that are unrelated to the changed balance date (for example, wages and salaries);
- the annualised amount of income (net of allowable deductions) from those activities for which the Commissioner has agreed the new balance date; and
- the average tax rate on the aggregate of those two amounts.

The following two examples illustrate the effect of the amendments in calculating a person's average tax rate.

Example 1: Transition year greater than 12 months

Bob, a partner in Bobbin & Co:

- Sought a change in the balance date for the partnership from 31 March to 31 May.
- Approval for the change was given on 14 Dec 2019 for the 2020 tax year.
- Return of income filed for period 1 April 2019 to 31 May 2020 (426 days).
- Partnership income share for 14 months to 31 May 2020 = $100K (2020 tax year).
- Interest & dividends for 12 months to 31 March 2020 = $200K (2020 tax year).

Applying the amended section 39(5) and (6), the annualised taxable income (The 2020 tax year being a leap year) would be:

= $200,000 + ($100,000 × 366 ÷ 426) = $285,915

Using the marginal rates of tax from schedule 1 of the Income Tax Act 2007 (assuming no change in rates), the income tax that would be payable on this annualised amount of taxable income for the 2020 tax year is $85,271.95.

The basic tax rate under section 39(5) is calculated as equal to the average rate of tax on that annualised income, as follows:

= $85,271.95 ÷ $285,915 = 29.8242%

The income tax liability for the 2020 tax year is therefore calculated using this basic tax rate:

= ($200,000 + $100,000) × 29.8242% = $89,472.69

In the absence of section 39, the income tax liability for the 2020 tax year on $300,000 would be $89,920 (i.e. overtaxed).

Example 2: Transition year shorter than 12 months

Nina, a partner in Ninety & Co:

- Sought a change in the balance date of the partnership from 30 June to 31 May.
- Approval was given on 14 Dec 2019 for the 2020 tax year.
- Return of income filed for period 1 July 2019 to 31 May 2020 (336 days).
- Partnership income for 11 months to 31 May 2020 – $100K (2020 tax year).
- Interest & dividends for 12 months to 31 March 2020 - $200K (2020 tax year).

Applying the amended section 39(5) and (6), the annualised taxable income (the 2020 tax year being a leap year) would be:

= $200,000 + ($100,000 × 366 ÷ 336) = $308,928

Using the marginal rates of tax from schedule 1 of the Income Tax Act 2007 (assuming no change in rates), the income tax that would be payable on this annualised amount of taxable income for the 2020 tax year is $92,866.24

The basic tax rate under section 39(5) is calculated as follows:

= $92,866.24 ÷ $308,928 = 30.0608%

The income tax liability for the 2011–12 tax year is therefore calculated using this (flat) basic tax rate:

= ($200,000 + $100,000) × 30.0608% = $90,182.41

In the absence of section 39, the income tax liability for the 2020 tax year on $300,000 would be $89,920 (i.e. undertaxed).

Sections 39(1) and (2)

The amendments to section 39(1) and (2) of the Tax Administration Act 1994 ensure that the term "year" is read as a calendar year and not a 12-month period.

Transport in vehicle other than a motor vehicle

Section CX 19B (Income Tax Act 2007)
Section CX 17B (Income Tax Act 2004)

The amendments correct an unintended legislative change arising in the rewrite of income tax legislation to ensure that transport of an employee in a heavy goods vehicle is not a fringe benefit.

Key features

The effect of section CI 1(o)(vi) of the Income Tax Act 1994 was inadvertently omitted in rewriting the fringe benefit tax rules (FBT rules). Under this provision, an exclusion from fringe benefit tax was given for providing transport in a heavy goods vehicle.

The exclusion from FBT is because heavy goods vehicles are generally outside the FBT net as these vehicles are designed for the carriage of goods and not passengers. Typically, when transport is provided to a passenger employee in a heavy goods vehicle, it is in relation to the business of the employer. Some business activities require a person, in addition to the driver, to carry out those activities (for example, the business of furniture removal). The exclusion would also apply when an employee of a removal company is picked up from home on the way to the first removal task of the day.

Section CX 19B restores, to the Income Tax Act 2007, the effect of section CI 1(o)(vi) of the Income Tax Act 1994. A similar amendment is made in section CX 17B of the Income Tax Act 2004.

Application dates

New section CX 19B in the Income Tax Act 2007 applies from the start of the 2008–09 income year.

New section CX 17B in the Income Tax Act 2004 applies from the start of the 2005–06 income year.

Livestock and the definition of trading stock

Section YA 1 "trading stock", paragraph (ab) (Income Tax Act 2007)
Section OB 1 "trading stock", paragraph (a) (Income Tax Act 2004)

The amendment to the definition of "trading stock" corrects an unintended legislative change arising in the rewrite of income tax legislation and restores the law relating to the taxation of livestock disposed of as part of the sale of a business.

Key features

The definition of "trading stock" in the Income Tax Act 2004 differs from the corresponding definition in the Income Tax Act 1994. That difference has also been re-enacted into the Income Tax Act 2007.

Due to the unintended legislative change in the defined term "trading stock", there are some circumstances in which livestock would not necessarily be treated as trading stock in the same way it was under the provisions of the Income Tax Act 1994.

An example of the effect of this unintended legislative change occurs in section CB 2 of the Income Tax Act 2007 (section FB 3 in the Income Tax Act 2004 and Income Tax Act 1994). This rule ensures that, if a business is sold, and trading stock is included in the business assets being sold, part of the sale price is treated as a sale of trading stock (on revenue account). Without section CB 2, the sale of the assets would generally be on capital account.

Under section FB 3 of the Income Tax Act 1994, livestock would have been included in the meaning of "trading stock" and the consideration for the livestock would have been taxable.

The amendment ensures the law works as intended.

Application dates

The amendments to the Income Tax Act 2007 apply generally from the start of the 2008–09 income year. However, the amendment repealing the cross-reference to section CD 48 applies for income years beginning on or after 1 July 2009 (due to the repeal of section CD 48 from that date).

The amendments to the Income Tax Act 2004 apply from the start of the 2005–06 income year.

A "savings" provision protects a tax position taken on the basis of the existing law prior to 5 December 2014.

Pre-amalgamation losses

Section IE 3 of the Income Tax Act 2007

The amendment corrects an unintended legislative change arising in the rewrite of this provision, to ensure that a loss balance of an amalgamated company is carried forward past the date of amalgamation.

Background

An amendment to section IE 3 corrects an error in rewriting the amalgamation provisions. The amendment ensures that an amalgamated company in a resident's restricted amalgamation may carry forward its tax losses from an earlier income year only if both of the following requirements are satisfied:

- the loss is able to be carried forward to the year under the continuity rules; and
- the loss could have been grouped against the net income of each of the amalgamating companies for the part-year falling before the date of amalgamation.

Key features

Section IE 3(1): Application

Section IE 3 applies if the amalgamated company has, for the year of amalgamation, either or both of:

- a loss balance carried forward into the year of amalgamation for which shareholder continuity is satisfied up to the date of amalgamation: and
- a tax loss component arising in the year of amalgamation during the period up to the date of amalgamation (pre-amalgamation part-year period), such as the part of the net loss that relates to that part-year period.

Section IE 3(4), (5): Relationship with sections IA 3, IA 4 and IA 5

Section IE 3(4) provides that, when preparing its return of income for the year of amalgamation, the amalgamated company must treat the pre-amalgamation part-year period and the part-year period following the date of amalgamation (post-amalgamation part-year) as separate tax years.

Consequently, in the year of amalgamation the amalgamated company must apply the core provisions calculation of net income as if each of the pre- and post- part-year periods were separate tax years.

In addition, the general tax loss rules in sections IA 3, IA 4 and IA 5 do not apply to determine whether an amalgamated company may carry forward a loss balance past the date of amalgamation. Instead, the amalgamated company must apply sections IA 3, IA 4 and IA 5 to each of the pre- and post- part-year periods as if they are separate tax years.

Section IE 3(2): Tax losses and the pre-amalgamation part-year period

If the amalgamated company has a loss balance carried forward to the pre-amalgamation part-year period, under section IE 3(2):

- that loss balance must first be subtracted from the company's part-year net income (if any) up to the date of amalgamation (treating section IA 4(1)(a) as applying to this part-year period as if it were a tax year); and then
- any unused amount of that loss balance may be made available to another group company, provided the shareholding continuity and commonality rules are satisfied for the pre-amalgamation part-year period.

If any unused amount of that loss balance remains after applying the loss grouping rules, that amount is included in the amalgamated company's tax loss for the year of amalgamation under section IA 2, treating the part-year period as if it were a separate tax year.

If the amalgamated company has a net loss for the pre-amalgamation part-year period, that amount may also be made available to another group company, provided the shareholding continuity and commonality rules are satisfied for the pre-amalgamation part-year period. Again, if an unused amount of that loss balance remains after applying the loss grouping rules, that amount is included in the amalgamated company's tax loss for the year of amalgamation under section IA 2, again treating the part-year period as if it were a separate tax year.

Section IE 3(3): Tax losses and the post-amalgamation part-year period

Section IE 3(3) provides that a tax loss component of the amalgamated company may only be carried forward past the date of amalgamation if both of the following requirements are satisfied:

- the amalgamated company satisfies the continuity requirements for the tax loss component to the end of the year of amalgamation; and
- the tax loss component could have been grouped against the net income of each of the amalgamating companies for the pre-amalgamation part-year period, treating that period as a separate tax year.

However, if a tax loss component is either an attributed CFC net loss or a FIF net loss, an additional requirement is that the shareholding commonality requirement must be satisfied on the basis that the amalgamated company and all of the amalgamating companies are a wholly owned group.

Application date

The amendment applies from the start of the 2008–09 income year. A "savings" provision applies to protect tax positions taken on the basis of the existing law prior to this amendment.

Loss offsets – CIR ability to allow late election

Section IC 9 of the Income Tax Act 2007

The proposed amendment corrects an unintended change in legislation arising from the rewriting the Income Tax Act to ensure that the Commissioner may accept an election by a company to use the loss grouping rules after the last day for filing a return of income (a late election).

Key features

The policy intention is that a company may elect to make its tax loss available to another company in the same group of companies either by:

- the last day for filing a return of income; or
- a later date allowed by the Commissioner (late election).

The rewritten loss rules in the Income Tax Act 2007 do not clearly permit the Commissioner to allow such election by a company after the last day for filing the company's return of income.

The amendment restores the Commissioner's ability to accept a late election by a company to make its tax loss available to another company in the same group of companies.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Limit on a tax refund for an imputation credit account company

Section RM 13(3) of the Income Tax Act 2007

An amendment to section RM 13(3) clarifies which tax year is relevant in determining the limit on the amount of a tax refund due to an imputation credit account company (ICA company), which has not filed its return of income for the most recently ended tax year under an extension of time arrangement.

Background

In general, a tax refund due to an ICA company must not result in that company's imputation credit account (ICA) going into deficit (a debit balance). This policy also extends to transfers of overpaid and non-refundable tax to another company in the same wholly owned group of companies. This general rule empowers the Commissioner to require part-year ICA tax returns to be filed, to determine the balance of the company's ICA before releasing the refund.

Key features

Section RM 13(3) gives an exception to this general rule, if all of the following circumstances apply:

- the ICA company files its return of income and ICA returns under an extension of time arrangement;
- the company's return of income for the most recent tax year has not been filed at the date the refund is due (under the extension of time arrangement); and
- the company's return of income and ICA return for the tax year preceding the most recent year has been filed.

The purpose of this rule is:

- consistent with self-assessment for a company having an extension of time arrangement; and
- permits refunds to be processed quickly, with reduced compliance and administration costs.

The amendment resolves an ambiguity in section RM 13 that could allow the company to choose to limit the refund to the highest credit balance in the ICA for any prior tax year. The amendment ensures the law works as intended and, in conjunction with the requirement in section RM 13(2), limits a refund of tax (or a transfer of tax) to no more than the credit balance of the company's ICA at the end of the tax year immediately preceding the most recent year.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

Carrying back foreign investor tax credits

Section LP 3(1) to (4) of the Income Tax Act 2007

The amendment corrects an unintended legislative change to the foreign investor tax credits rules arising in rewriting the Income Tax Act.

Background

The foreign investor tax credits (FITC) rules in the Income Tax Act 2007 are intended to ensure that the total New Zealand tax on income derived by a non-resident investor through a corporate structure does not exceed the company tax rate (currently 28%).

As part of that design, the FITC rules are also intended to permit a New Zealand company to either:

- carry forward unused FITC; or
- carry back unused FITC from one year to any one or more of four immediately preceding years, to satisfy the company's income tax liability in the earlier year.

The rewritten provisions of the Income Tax Act 2007 allowing the carry back of FITC have been interpreted as permitting the carry back of these tax credits to be made to only one of those four immediately preceding years, instead of to any one or more of the four preceding years. That outcome is inconsistent with the policy intent and the amendment ensures the legislation works as intended.

Key features

The amendments clarify that a company may carry back unused FITC from one year to any one or more of four immediately preceding years, to satisfy the company's income tax liability in the earlier year.

NEW LEGISLATION

Application date

The amendments apply from the beginning of the 2008–09 income year.

Land sales: duplicate provisions

Section CB 6(3) of the Income Tax Act 2007

The amendment repeals section CB 6(3) as it duplicates the outcome given by section CB 23B.

Background

Section CB 23B was inserted into the Income Tax Act 2007 by the Taxation (Business Taxation and Remedial Matters) Act 2007. This amendment provides for the same outcome as given by section CB 6(3) and applied from the beginning of the 2008–09 income year.

The Rewrite Advisory Panel determined that only one of the provisions is necessary and that the repeal of one of the provisions would not affect the law. As the subject matter of the provisions relates to all the land sales rules, section CB 23B has been retained to improve clarity and access to the law. As a result, section CB 6(3) has been repealed.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Non-resident passive income and definition of non-filing taxpayer

Sections RB 2, RF 2 and YA 1 of the Income Tax Act 2007

The amendments improve the clarity of the relationship between sections RB 2, RF 2 and the definition of "non-filing taxpayer" in the Income Tax Act 2007 following a cross-reference error in rewriting the non-resident withholding tax rules. The amendment corrects this unintended legislative change and eliminates some overlap, which ensures the provisions work as intended.

The amendments:

- correct the cross-reference in the definition of "non-filing taxpayer" to refer to section RF 2(3) instead of section RB 2;
- consequentially repeal section RB 2 as it overlaps with section RF 2; and
- eliminate overlap between section RF 2(4) and section RF 2(3).

These amendments clarify that:

- if a non-resident's only income derived from New Zealand is non-resident passive income subject to final withholding, the non-resident is a non-filing taxpayer; and
- if a non-resident derives other types of income during an income year, in addition to non-resident passive income subject to final withholding, the non-resident must file a return of income for that year.

Application date

The amendments apply from the date of enactment, being 30 March 2017.

Bad debt deductions for holders of debt – base maintenance change

Section DB 31 of the Income Tax Act 2007

Changes introduced by the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014 were intended to align the tax rules with the policy settings for taking bad debt deductions, by limiting bad debt deductions that can be taken by dealers and holders of debt to the economic cost of the debt. These changes were discussed in two editions of the *Tax Information Bulletin*, (Vol. 26 No. 4, May 2014 and Vol. 28 No. 3, April 2016).

Background

As part of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014, changes were made to the bad debt deduction rules to prevent deductions when no economic loss has been suffered. One of the changes deferred bad debt deductions for debts funded by and matched to limited recourse arrangements, to the maturity, disposal or remittance of the limited recourse arrangements.

However deferral of the bad debt deduction in those circumstances could, when the associated limited recourse arrangements were accounted for under the financial arrangement rules, create an unintended effect. This occurred when income arose on the related limited recourse arrangements under the fair value method under section EW15D in a year prior to the base price adjustment (BPA) on the limited recourse arrangements. This created a mismatch in that income year, as the income on the limited recourse arrangements is taxable while the related bad debt deduction is deferred. The situation should reverse when the BPAs are made on both arrangements but a timing mismatch arose in the meantime, which had the potential to become permanent in some circumstances.

This situation could be particularly relevant for securitisation vehicles that use the fair value spreading method for tax under section EW 15D for their assets and related liabilities (that are limited recourse arrangements).

Key features

Section DB 31(4B)(c), (as inserted by the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2016, is intended to ensure that, prior to the BPA of the limited recourse arrangement, dealers and holders of the same or similar financial arrangements can only take bad debt deductions under section DB 31(3) for the money at risk.

Section DB 31(4D) is intended to ensure that when a BPA for the limited recourse arrangement is performed, dealers and holders of the same or similar financial arrangements are allowed a deduction for amounts owing under the debt for which deductions have not been taken under section DB 31(2) or (3).

The changes to section DB 31(4C)(b) corrects the timing mismatch in the bad debt deduction rules referred to above by allowing a bad debt deduction in an income year to match income on limited recourse arrangements in the same income year when using section EW 15D (IFRS financial reporting method).

To illustrate the changes, Example 5 from *Tax Information Bulletin* Vol. 28 No. 3, April 2016 is repeated here, but with some factual changes to illustrate the effect of the changes.

Example 5

Co B (a holder of the same or similar financial arrangements) lends money to Co A. Under this debt arrangement, Co B lends Co A $1,000 repayable in five years with $100 interest payable each year. Co B funds the loan to Co A by borrowing $1,000 from Co C (a limited recourse arrangement). Under the arrangement with Co C, Co B is only required to repay the $1,000 and interest to Co C to the extent that Co A pays these amounts to Co B.

All interest is received when due each year; $80 received during the liquidation of Co A; Co B is an accruals-basis taxpayer. However, bad debt deductions are taken in a year prior to the year in which the BPA is performed for the limited recourse arrangement.

[**Note:** *Changes to the example as a result of the Taxation (Annual Rates for 2016 – 17, Closely Held Companies, and Remedial Matters) Act 2017 are shown in italics. The main changes are that all the debt is financed by a limited recourse arrangement and there are fair value changes on the debt and the limited recourse arrangement in year 4.*]

Assume that Co A paid Co B all interest amounts when they fell due. Co A was put into liquidation, after the last interest payment was received but the principal was not repaid. Only $80 of the remaining $1,000 repayable was received during the liquidation of Co A. *This means Co C receives a total of $500 from interest payments, and Co C also receives $80 on liquidation of Co A. In this case Co B is cash-neutral from both arrangements overall, being the cash flow from the limited recourse arrangement ($1000 – $580) + cash flow from the debt ($580 – $1,000).* (It is assumed for simplicity that the BPAs for both arrangements take place in the same year.)

Further assume that both the debt and the limited recourse arrangement are accounted for and taxed using the fair value spreading method under section EW 15D (IFRS financial reporting method). Under that method, in year 4 an impairment of $250 is recognised in the fair value of the loan to Co A (a debit to profit) and a reduction of $250 in the fair value of the limited recourse arrangement (a credit to profit) is also recognised. The reduction in fair value of the limited recourse arrangement reflects its nature as being limited to the value of the related debt.

The $250 debit to profit for the impairment of the debt is an impaired credit adjustment under section EW 15D(3)(a) and is therefore not deductible. However, Co B has actually written off $250 of the debt owing by Co A in year 4, represented by the accounting fair value impairment of $250 to the loan.

Correspondingly Co B has increased income of $250 from the fair value reduction in the limited recourse arrangement as credited to profit. This income is taxed under the IFRS financial reporting spreading method.

While these rearranged facts are somewhat artificial, they help to illustrate the latest change to the rules.

NEW LEGISLATION

Debt

For Co B, the cash flow under the debt is a loss of $420 ($580 received – $1,000 lent). Co B's overall tax position should reflect this.

However, Co B decided in year 4 that it is not going to recover $250 of the debt owing by Co A and writes off $250. It wants to claim a bad debt deduction in year 4 to the extent possible for the bad debt written-off.

Co A has been paying all its interest, which has been returned as accrual income by Co B. In year 4 it also has an accounting loss of $250 from the fair value impairment of the loan that is not deductible for tax under section EW 15D(3)(a), and an accounting fair value gain of $250 on the limited recourse arrangement, which is assessable for tax. The effect of these two amounts is $250 assessable income under the spreading method due to the non-deductibility of the impairment on the loan. *It is this timing mismatch that the changes in the Taxation (Annual Rates for 2016 – 17, Closely Held Companies, and Remedial Matters) Act 2017 are intended to correct.*

It is assumed that the bad debt deduction is not being claimed under section DB 31(2) because the amount written off is not an amount owing related to that income. So the deduction will need to be claimed for an amount owing under section DB 31(3).

Section DB 31(3B) limits the deduction to the lesser of the amount provided by subsection (4B) and the amount provided by subsection (5). Subsection (5) is assumed to be not relevant here so the amount of the deduction will be determined by subsection (4B).

Subsection (4B) provides that the amount of the deduction is the least of –

Para (a), is the amount that Co B pays for acquiring the financial arrangement (debt), being $1,000 in this case. Co B acquired the debt by lending $1,000 to Co A:

Para (b), is the amount owing under the financial arrangement, being $1,000 in this case:

Para (c), is the amount calculated using the formula:

Amount owing ($1,000) – limited recourse consideration ($1,000) + *adjustment amount ($250*)* = $250

(**adjustment amount** is an amount allocated for the income year under section EW 15D (IFRS financial reporting method) for the limited-recourse arrangement, to the extent to which the amount arises solely because of the reduction in the value of the limited-recourse arrangement due to the financial arrangement's relevant bad debt amount. This amount is the $250 credited to profit representing the reduction in value of the limited recourse arrangement and has arisen due to the bad debt of $250.*

The amount of the deduction for the bad debt written off in year 4 is therefore limited to $250 by subsection (4B)(c). This happens to be the amount actually written off so Co B can claim a deduction for that amount in year 4.

In year 5 the BPAs for the debt and the limited recourse arrangement are performed.

Co B's BPA for the debt (between Co A and Co B) is:

BPA: Consideration – income + expenditure + amount remitted
= ($580 – $1,000) – $400 + $0 + $920
= $100

Tax position:

- The BPA performed under the debt arrangement will result in $100 of income for Co B. This amount represents interest received in the last year of $100.
- Co B was required to return $400 interest income received from Co A in years 1 to 4.
- Co B was not allowed a deduction for the $250 fair value impairment loss of $250 in year 4.
- To align the tax position with the cash flow position (the loss of $420); a deduction of $920 is required.
- In this example a bad debt deduction was taken under section DB 31 (3) for $250 in year 4.
- Co B is allowed an additional bad debt deduction under section DB 31(4D) for $670 when the BPA for the limited recourse arrangement is performed. This is calculated as the amount owing under the debt ($920) less the total deductions under subsections (2) & (3) prior to the BPA for the limited recourse arrangement being performed (that is, $250 under subsection (3) in year 4).

This is the correct tax result overall for the debt, as it aligns with the cash loss of $420.

Interest income returned	$400
BPA income returned	$100
DB 31(2) and (3) deductions	($250)
DB 31(4D) deduction	($670)
Total	($420)

Limited recourse arrangement

For Co B the cash flow under the limited recourse arrangement is a gain of $420 ($1,000 received – $580 paid). Co B's overall tax position should reflect this.

Co B's BPA for the limited recourse arrangement (between Co B and Co C) is:

BPA: Consideration – income + expenditure + amount remitted

= ($1,000 – $580) – $250 + $400 + $0

= $570

Tax result for the limited recourse arrangement in the BPA income year:

- The BPA performed under the limited recourse arrangement will result in $570 of income for Co B.
- Deductions of $400 for interest paid to Co C in prior years under the limited recourse arrangement would be allowed under section DB 7 ($100 each year for years 1 to 4).
- Fair value gains of $250 were taxed in year 4.
- This gives the correct tax result for Co B under the limited recourse arrangement as the tax position ($570 income – $400 deductions + $250 fair value gains) aligns with the cash flow ($420 gain).

Summary of tax in all years for both arrangements

	Years 1–4	*Year 5 (BPA year)*
Interest income on debt	$400	$0
Interest expenditure on LRA	($400)	$0
Fair value gains on LRA	250	$0
BPA income on debt	$0	$100
BPA income on LRA	$0	$570
DB 31(3) deduction	($250)	$0
DB 31(4D) deduction	$0	($670)
Total	$0	$0

Note that section BD 4(5) allocates deductions to income years so their total does not exceed the amount of the expenditure or loss.

Application dates

The changes apply from 20 May 2013, the date the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill was introduced.

R&D loss tax credit remedials

Section MX 7 of the Income Tax Act 2007

The amendments create ordering rules for when multiple loss reinstatement events occur in a single income year. The intention is to simplify the payment of R&D repayment tax and protect the tax base. The changes also clarify that, when a loss of shareholder continuity has resulted from equity disposals and transfers, all equity disposals and transfers from the year a credit was first taken to the current year should be included in calculating R&D repayment tax.

Background

It is possible that a loss of shareholder continuity and the appointment of a liquidator and/or a loss of eligibility can take place in a single income year, creating multiple R&D repayment tax liabilities. The previous legislation did not adequately address how R&D repayment tax should be paid in this situation.

The legislation did not require R&D repayment tax arising from the sale, transfer or disposal of intellectual property when a loss of shareholder continuity (an effective sale of the company) also occurs. This posed a risk to the tax base, as the value of the shares in a company are likely to be very low if the company's intellectual property has been sold.

Finally, previous section MX 7(4) did not make it sufficiently clear that equity disposals and transfers that occurred in an earlier year than the year the loss of shareholder continuity took place are now included in the calculation of R&D repayment tax.

Key features

An ordering rule has been added to modify the application of section MX 7(4) by prescribing that if there is a loss of shareholder continuity and a liquidator is appointed and/or the company suffers a loss of eligibility, the loss of continuity does not give rise to R&D repayment tax. This is because the latter events require the balance of the R&D loss tax credit to be repaid in full as R&D repayment tax.

Section MX 7(2) has been amended to ensure that the company will be liable for R&D repayment tax if the sale of intellectual property and a loss of shareholder continuity occur in the same income year, as neither of these events may create a liability to repay the balance of the R&D loss tax credit in full.

Section MX 7(4)(b) has been amended to clarify that, in the event of a loss of shareholder continuity, all equity disposals and transfers from the year a credit was first taken to the current year should be included in calculating R&D repayment tax.

Application date

The amendments apply for the 2016–17 and subsequent income years.

Exempt income from personal services – the 92-day rule

Section CW 19 of the Income Tax Act 2007

The amendment to section CW 19 aligns the provision's count test with other count tests by measuring the days of personal presence within any 12-month period. The amendment provides that a non-resident deriving income from personal services carried out in New Zealand is not taxable on that personal services income if that visit does not last for more than 92 days in any 12-month period.

Background

The original policy intention and legislation for this exemption was crafted in a period when New Zealand did not have a count test for determining tax residence for a natural person (that is, personal presence in New Zealand for more than 183 days in any 12-month period). At that time, the only test of residence was by reference to whether the person had a permanent dwelling place in New Zealand.

The amendment to section CW 19 updates the law and improves the integrity of the tax system by bringing the count test into line with the domestic residency rule for natural persons and the similar count test used in double taxation agreements for individuals.

Key features

A non-resident person may derive exempt income from providing personal services in New Zealand if they meet the requirements of section CW 19.

Before the amendment to section CW 19, New Zealand provided a unilateral exemption for income derived from personal services provided in New Zealand by a non-resident if the person is not present in New Zealand for more than 92 days in a tax year.

Under this rule, a taxpayer could arrange for their visit to straddle the 31 March and remain in New Zealand for up to 182 consecutive days within a 12-month period without becoming a New Zealand resident, and also be exempt on personal services income derived from New Zealand during this period.

This was inconsistent with the count tests in our network of double taxation agreements and the domestic test of tax residence. The domestic tax residence test contains a personal presence rule, which focuses on whether a person is present in New Zealand for more than 183 days in a 12-month period.

Following the amendment, a non-resident coming to New Zealand to perform personal services in New Zealand will be taxable on income derived from those services if the visit lasts for more than 92 days in any 12 month period. In a practical sense, before coming to New Zealand to perform personal services in New Zealand, the non-resident will need to:

- take into account the new 92-day count test in determining if their personal services income is exempt income;
- apply for an exemption certificate if they do not wish to have their New Zealand income subject to PAYE within that 92-day period; and
- be aware of the circumstances in which they will be required to file an income tax return (if the visit is extended beyond the 92-day period).

Application date

The amendment applies to a visit that begins or after 1 April 2017.

Tax status of Employment Relations Authority members

Section RD 5(5) of the Income Tax Act 2007

Amendments have been made to the Income Tax Act 2007 to ensure that the salaries and allowances of Employment Relations Authority (ERA) members are subject to PAYE.

PAYE generally applies to individuals who meet the common law definition of "employee" and receive salary and wages. Section RD 5(5) of the Income Tax Act 2007 expands the meaning of "salary and wages" to include "salary and principal allowances made to a judicial officer" that are "made under a determination of the Remuneration Authority". Section RD 5(5) was originally enacted to codify existing practice at the time, which was that judges' salaries were subject to PAYE.

The Income Tax Act does not provide a legislative definition for "judicial officer", which resulted in some uncertainty about whether ERA members came under the definition and were subject to PAYE. The amendment ensures that the definition of "salary and wages" includes salary and allowances paid to ERA members, consistent with the policy intent.

Withholding tax at source is desirable for the efficient administration of tax, and PAYE is the appropriate method for taxing the salaries of ERA members, as they are paid regular salaries and work full-time. Applying the M code under the PAYE rules deducts the correct amount of tax under New Zealand's progressive tax rate scale.

Key features

Amendments have been made to section RD 5(5) of the Income Tax Act to:

- ensure that the salary and allowances of Employment Relations Authority members are subject to PAYE; and
- define the term "judicial officer" to mean officers listed in section 12B of the Remuneration Authority Act, namely judges of courts, and coroners.

Application date

The amendments came into force on the date of enactment, being 30 March 2017.

Depreciation recovery income – cross-references

Sections EE 44, EE 47, EE 49(8), and YA 1 of the Income Tax Act 2007
Section EE 42(8) of the Income Tax Act 2004

The amendments correct cross-references in the depreciation rules of the Income Tax Act 2007, along with relevant corresponding provisions in the Income Tax Act 2004.

Background

These amendments relate to the rules about partial business use of an asset, and to the rules relating to calculation of depreciation recovery income and the definition of "consideration".

The policy intent is that if a person derives consideration on disposal of a depreciable asset in excess of the tax depreciated value (adjusted tax value), the person derives depreciation recovery income, calculated as the lesser of:

- the person's total allowable depreciation deductions for depreciation loss for that asset; or
- the difference between the consideration and the adjusted tax value.

The calculation of depreciation recovery income for depreciable property that has partial business use is intended to be determined by the amount of business use of that asset.

The amendments to the cross-references ensure the law works as intended.

Key features

There are two different types of remedial amendments, which correct cross-references in the following rules:

- The rules relating to partial business use of an asset – The cross-reference in section EE 49(8) of the Income Tax Act 2007 has been changed from section EE 48(1) to section EE 48(1)(a), and the cross-reference in section EE 42(8) of the Income Tax Act 2004 has been changed from section EE 41(1) to section EE 41(1)(a).

NEW LEGISLATION

- The rules relating to calculation of depreciation recovery income and in the definition of "consideration" – The cross-reference in sections EE 44, EE 47 and in paragraph (a) of the definition of "consideration" in section YA 1 of the Income Tax Act 2007 has been changed from sections EE 48 to EE 52 to sections EE 48 to EE 51.

Application dates

The amendment to section EE 49(8) of the Income Tax Act 2007 applies from the start of the 2008–09 tax year.

The amendment to section EE 42(8) of the Income Tax Act 2004 applies from the start of the 2005–06 tax year. There is a "savings" provision for both amendments for taxpayers who have taken a tax position on the law as it existed before 3 May 2016 (the date of introduction of the amending bill).

The amendments to sections EE 44, EE 47 and in paragraph (a) of the definition of "consideration" in section YA 1 of the Income Tax Act 2007 apply from the date of enactment, being 30 March 2017.

Capital loss amount

Section CD 44(9) of the Income Tax Act 2007
Section CD 33(9) of the Income Tax Act 2004

Amendments have been made, to clarify that for a company, a tax-deductible depreciation loss arising on disposal of a depreciable asset is not taken into account in determining the value of a capital gain amount that may be distributed tax-free.

Background

Provided capital gains derived by a company from disposing of capital property are not "tainted capital gains" (refer to the item on other amendments to the capital gains rules in this *Tax Information Bulletin*), the total amount of net capital gains derived by a company from the disposal of capital property may be distributed tax-free in the following circumstances:

- on liquidation of a closely held company; or
- if made to a shareholder of a look-through company or a qualifying company.

Net capital gains that may be distributed tax free by a company are the difference between total capital gains (non-tainted) and the total of capital loss amounts. Capital property is all property that is not revenue account property and includes depreciable property.

Before these amendments, the calculation of a capital loss amount on disposal of an item of depreciable property took into account accumulated tax depreciation on the property.

Key features

The amendments clarify that, for an item of depreciable property, a capital loss on disposal of the property is determined by reference to its adjusted tax value at the time of disposal. Before the amendments were made, a capital loss was required to be calculated as the difference between consideration on disposal of the item of depreciable property and the cost of that asset.

Application dates

The amendment to the Income Tax Act 2007 applies from the start of the 2008–09 income year.

The amendment to the Income Tax Act 2004 applies from the start of the 2005–06 income year.

A "savings" provision applies to tax positions taken (before 30 March 2017) on the calculation of a capital loss that is consistent with the amendment.

Detailed analysis

The policy intent is that the calculation of a capital loss should not include any amount that has been previously allowed as a deduction by way of depreciation to the company.

Before the amendments, for a company that has disposed of capital property:

- net capital gains for disposals of capital property was equal to the difference between total capital gain amounts and total capital loss amounts;
- a capital loss amount on disposal of an item of capital property was the amount by which the cost of the property exceeded the consideration derived on disposal; and

- if the capital property was an item of depreciable property, the capital loss amount would include accumulated tax depreciation that had previously been allowed as a deduction to the company to the extent the accumulated tax depreciation had not been recovered on disposal.

The amendments ensure that for buildings, the correct capital loss amount is calculated. However, for an item of other types of depreciable property, the amendments do not correctly exclude all accumulated tax depreciation from the capital loss amount. This is expected to be corrected by way of a remedial amendment at a future date.

The following examples illustrate how the amended provision is intended to apply.

Example 1: Disposal of a building – consideration on disposal less than adjusted tax value

PropertyCo acquired land and buildings with a cost of $1m in 2008 as capital property. The land and buildings were disposed of in the 2017–18 income year for a consideration of $900,000. At disposal, accumulated tax depreciation on the building (before the removal of tax depreciation for buildings) was $60,000.

	After amendment to section CD 44(9)	Before amendment to section CD 44(9)
	$	$
Cost of land and building	1,000,000	1,000,000
Adjusted tax value at disposal	940,000	940,000
Consideration on disposal	900,000	900,000
Capital loss amount	40,000	100,000

After the amendment to section CD 44(9), the capital loss amount is consistent with the policy intention.

Example 2: Disposal of a building – consideration on disposal less than cost but greater than adjusted tax value

PropertyCo acquired land and buildings with a cost of $1m in 2008 as capital property. The land and buildings were disposed of in the 2017–18 income year for a consideration of $980,000. At disposal, accumulated tax depreciation on the building (before the removal of tax depreciation for buildings) was $60,000.

	After amendment to section CD 44(9)	Before amendment to section CD 44(9)
	$	$
Cost of land and building	1,000,000	1,000,000
Adjusted tax value at disposal	940,000	940,000
Consideration on disposal	960,000	96,000
Capital loss amount	0	40,000

After the amendment to section CD 44(9), the capital loss amount is zero, and this consistent with the policy intention.

Example 3: Disposal of plant – consideration on disposal less than adjusted tax value

ManufacturingCo acquired an item of plant with a cost of $1m in 2012. The plant was disposed of in the 2017–18 income year for a consideration of $550,000. At disposal, accumulated tax depreciation on the plant was $360,000. A depreciation loss of $90,000 is an allowable deduction on the disposal.

	After amendment to section CD 44(9)	Before amendment to section CD 44(9)
	$	$
Cost of land and building	1,000,000	1,000,000
Adjusted tax value at disposal	640,000	640,000
Consideration on disposal	550,000	550,000
Capital loss amount	0	450,000

Note: this example (which is consistent with the policy intention) assumes the remedial amendment referred to above has been made.

NEW LEGISLATION

Example 4: Disposal of plant – consideration on disposal more than adjusted tax value

ManufacturingCo acquired an item of plant with a cost of $1m in 2012. The plant was disposed of in the 2017–18 income year for a consideration of $700,000. At disposal, accumulated tax depreciation on the plant was $360,000. ManufacturingCo has depreciation recovery income of $60,000 at disposal.

	After amendment to section CD 44(9)	Before amendment to section CD 44(9)
	$	$
Cost of land and building	1,000,000	1,000,000
Adjusted tax value at disposal	640,000	640,000
Consideration on disposal	700,000	550,000
Capital loss amount	0	450,000

MINOR MAINTENANCE ITEMS

The amendments listed in the table reflect minor technical maintenance items arising from both the rewrite of income tax legislation and general drafting matters and correct or update any of the following:

- ambiguities;
- compilation errors;
- cross-references;
- changes for drafting consistency, including readers' aids – for example, the defined terms lists;
- grammar;
- punctuation;
- spelling;
- consequential amendments arising from substantive rewrite amendments; or
- the consistent use of terminology and definitions.

Minor maintenance items: Amendments and commencement dates

Section in amending Act	Income Tax Act 2007	Amendment	Commencement date
23(3)	CD 44(10B)	Correction to cross-reference	1 April 2010
39	CX 47(4)(a)	Correction of terminology	30 March 2017
48	DB 19	Correction of defined terms list	30 March 2017
56	EC 26B	Correction of defined terms list	30 March 2017
60	EE 41(2)(b)(i)	Correction to cross-reference	30 March 2017
68	EJ 2(1)	Correction to cross-reference	1 April 2014
70	EW 5(3D)	Correction of terminology	30 March 2017
101(2)	FE 2	Correction of defined terms list	30 March 2017
103	FE 9(3)	Correction of terminology and cross-referencing.	1 April 2008
116	FO 20(1)	Correction to cross-reference	30 March 2017
118	FZ 6(1)	Correction of terminology	30 March 2017
134–138	HG 5–HG 9	Correction of defined terms list	30 March 2017
139	HG 11	Correction of defined terms list	30 March 2017
140	HM 3(2)	Correction to cross-reference	2 November 2012
162	LP 2	Correction of terminology	1 April 2008
256	RA 15(3)	Correction to cross-reference	1 April 2008
259	RD 3(2)–(4), defined terms	Correction of terminology	1 April 2008
263	RD 21(3)	Correction of terminology	1 April 2008
288(10)	YA 1 "close relative"	Correction of terminology	30 March 2017
288(19)	YA 1 "distant workplace"	Correction of drafting error	4 September 2010
288(30)	YA 1 "exiting partner"	Inserts a definition for an existing term "exiting partner"	30 March 2017
288(76)–(78)	YA 1 "out of town secondment"	Correction of drafting error	(76)–4 September 2010 (77), (78) 1 April 2015
288(80)–(82)	YA 1 "PCA" "PCA company" "PCA person"	Repeal redundant terms	30 March 2017
288(83)–(85)	YA 1 "period of continuous work"	Correction of drafting error	(83)–4 September 2010 (84), (85)–1 April 2015
288(87)–(89)	YA 1 "project of limited duration"	Correction of drafting error	(87) –4 September 2010 (88), (89)–1 April 2015
288(110)	YA 1 "tax-base property"	Correction of terminology	30 March 2017
297	Schedule 32	Remove from the list a charity that has been wound up	3 December 2015

Section in amending Act	TAA 1994	Amendment	Commencement date
316	69(1)(g)	Repeal redundant paragraph	30 March 2017
340	174AA	Correction of terminology	1 April 2008

Section in amending Act	Goods and Services (Grants and Subsidies) Order 1992	Amendment	Commencement date
398	Schedule to Goods and Services (Grants and Subsidies) Order 1992	Repeal redundant item	30 March 2017

FBT AND SPECIFIED INSURANCE PREMIUMS

Sections CE 5(2), (3) and CX 16(3)–(6) of the Income Tax Act 2007

The amendment simplifies the fringe benefit tax (FBT) treatment of premiums paid by an employer for life insurance policies taken out by an employer on employees' lives (or a spouse, civil union partner or de facto partner or a joint policy, or on the life of their child).

Background

Before the amendment, the FBT rules relating to premiums paid by an employer in relation to a life insurance policy taken out by the employer on an employee's life was confusing due to:

- tautologies or redundancies in the wording; and
- overlapping rules, which have different thresholds.

Key features

The amendments to sections CE 5 and CX 16 clarify that all life insurance premiums for life insurance policies, including group life insurance premiums other than those paid within a superannuation fund, taken out by an employer on employees' lives (or a spouse, civil union partner or de facto partner or a joint policy, or on the life of their child) are treated as specified insurance premiums for the purpose of the fringe benefit tax rules.

The amendment aligns the law with the practice of many taxpayers and their advisors, which treats these premiums as specified insurance premiums for FBT purposes. This simplifies the calculation of FBT for these premiums.

Application date

The amendment came into force on the date of enactment, being 30 March 2017.

INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 17/04: Income tax – computer software acquired for use in a taxpayer's business

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

Scope of this statement

1. This statement covers the income tax treatment of software for taxpayers who purchase, lease, licence, develop, or commission software for use in a business carried on for the purposes of deriving assessable or excluded income. The statement expressly refers only to taxpayers that are carrying on a business. However, except where otherwise stated, the principles in this statement also apply to taxpayers who incur expenditure on software in deriving assessable or excluded income (otherwise than in the course of carrying on a business).
2. This statement does not consider:
    - the income tax treatment of software for taxpayers that develop software for third parties – e.g to earn income from the sale or licence of the software (software developers);
    - the treatment of software funded by a government grant and, in particular, the application of s DF 1; or
    - the application of any specific research and development provisions other than s DB 34; or
    - any potential withholding tax obligations that a taxpayer may have – for example, for royalties or interest paid to a non-resident software supplier, or for services provided by a non-resident contractor. These issues are covered in IG0007 "Non-resident software suppliers' payments derived from New Zealand – Income tax treatment" *Tax Information Bulletin* Vol 15, No 11 (November 2003) (it is noted that this statement is due to be reviewed).

Summary

3. The following is a brief summary of the main income tax implications of acquiring or developing software for use in a business. Further details are set out in the analysis section below.

Software purchases

- Software purchased will generally be a capital asset that must be depreciated at 50% diminishing value or 40% straight-line.
- An immediate write-off for software costing less than $500 will be allowed where the conditions in s EE 38 are satisfied.
- Maintenance costs may be deducted when incurred.
- Upgrade costs must be capitalised and depreciated.

Periodic payments for the right to use or access software

- Periodic payments for the right to use or access software (often online software) are generally deductible when incurred.

Software developed in-house for use in business

- In limited situations a deduction may be allowed for expenditure in determining the feasibility of developing a piece of software for use in a business. Where such a deduction is not available, then unless another provision applies allowing a deduction (such as s DB 34), the expenditure should be capitalised until the software is either completed or abandoned.
- If the software is completed for use in the taxpayer's business, the cost of the software can be depreciated at 50% diminishing value or 40% straight-line.

- If software is abandoned before it becomes depreciable property, a deduction may be allowed for the expenditure incurred in developing the software.
- Expenditure incurred in maintaining software once it has been completed will generally be deductible when incurred.
- Upgrade costs must be capitalised and depreciated.

Commissioned software

- Expenditure on software commissioned by a taxpayer for use in its business should be capitalised until the software is complete. The costs can then be depreciated over the life of the item.
- If the software is abandoned before it becomes depreciable property, a deduction may be allowed for the expenditure incurred in developing the software.

Lease of software under finance lease

- Software leased under a finance lease is treated as a sale of software by the lessor to the lessee. Also, the lessor is treated as giving a loan to the lessee for the software and the lessee is treated as using the loan to buy the software.
- The Act then applies to the arrangement as recharacterised.
- The financial arrangements rules apply to the loan.
- The depreciation rules apply as if the lessee owned the software.
- The treatment at the end of the finance lease depends on who acquires the rights to the software at the end of the lease term.

Introduction

4. In 1993, the Commissioner published a policy statement setting out the income tax treatment of computer software (see Appendix to *Tax Information Bulletin* Vol 4, No 10 (May 1993)). A number of parts of that item were out of date. Consequently, "IS 16/01: Income tax – Computer software acquired for use in a taxpayer's business" *Tax Information Bulletin* Vol 28, No 6 (July 2016) was issued to replace the 1993 item except for the parts of that item that deal with taxpayers carrying on a software development business.
5. In February 2017, the Commissioner issued a revised statement on feasibility expenditure ("IS 17/01: Income tax – Deductibility of feasibility expenditure" *Tax Information Bulletin* Vol 29, No 3 (April 2017)). That statement sets out the Commissioner's view on the deductibility of expenditure incurred in determining the feasibility of acquiring or developing a capital asset. This item replaces IS 16/01, which has been updated to the extent that it applied the Commissioner's previous view on feasibility expenditure.

Analysis

6. This statement covers the income tax treatment of software for taxpayers who:
   - purchase software for use in their business;
   - make periodic payments for the right to use software (other than under a finance lease) in their business;
   - develop software in-house for use in their business;
   - commission software development for use in their business; or
   - lease software under a finance lease for use in their business.
7. Each of these situations is considered below. As the depreciation provisions are relevant to four of the situations, a more general discussion on depreciation is included after the discussion of the specific scenarios.

Software purchases

8. When software is purchased (whether "off the shelf" or online), generally the purchase price will be paid for the right to use the software (in the form of a licence). A taxpayer who acquires software for use in a business gets an enduring benefit. The expenditure incurred is capital in nature and non-deductible, but the taxpayer can claim depreciation on the software over its life.
9. The cost of maintaining the software is deductible expenditure under s DA 1. The cost of upgrades must be capitalised and depreciated. The depreciation treatment is discussed in more detail below (from [35]).

Periodic payments for the right to use or access software

10. Where a taxpayer makes periodic payments for the right to use or access software (other than software leased under a finance lease), the payments will generally not give rise to a capital asset. This can occur, for example, where a taxpayer pays a periodic licence fee for the right to use software or where a taxpayer pays a subscription fee to access software online (also known as software as a service). The payments will be deductible under s DA 1 (subject to the general limitations in s DA 2). A deduction will be allowed in the income year that the expenditure is incurred, unless a specific timing provision applies.

Software developed in-house for use in business

11. A business (not including a software development business) may develop software in-house for use in its own business. Developing software in-house will generally create a capital asset. The tax treatment of the costs incurred in the software development will differ for different phases of the development. In summary, the following principles apply.

Expenditure developing the software

12. In limited cases, early stage feasibility expenditure (ie expenditure incurred analysing the feasibility of developing a piece of software for use in a business) may be deductible. The Commissioner's view on the deductibility of feasibility expenditure is set out in the interpretation statement IS 17/01: "Income Tax – Deductibility of Feasibility Expenditure" (*Tax Information Bulletin* Vol 28, No. 3 (April 2017)).
13. Where a deduction is not available, expenditure should be capitalised until the software is either completed or abandoned. This includes both direct costs and indirect costs. Direct costs include personnel costs directly attributable to the project, and depreciation costs on hardware dedicated to the project. Indirect costs are overhead costs that cannot be directly linked to a particular project. These may include general overhead costs (such as rates, rent, insurance, and energy costs), indirect labour costs, and indirect material costs (such as paper, and printer toner).
14. Direct costs should be relatively easy to calculate (for example personnel costs can be calculated by recording the direct hours spent by staff on a project).
15. Indirect costs (including utility costs, rental or ownership costs of property etc…) should be allocated using a method that gives a fair and reasonable result. A possible allocation method might be based on the proportion of direct person hours allocated to the project. Where accurate time recording is not undertaken, a functional analysis of what each employee working on the project does may be appropriate. However, a taxpayer can use another method if it can be shown that it is appropriate. For example, in some circumstances, a method based on the proportionate time and space used for the project may be appropriate.
16. If the software is completed for use in the taxpayer's business its cost can be depreciated (see from [35] below). To be depreciable, the software must be used or available for use. In the Commissioner's view, a piece of software will be available for use when it is capable of being used for the purpose that it was developed. This is likely to be after it has been tested to determine that it works as intended and when it is ready (or materially ready) to 'go live'.
17. For depreciation purposes, s EE 18B includes the amount of expenditure incurred in developing the software as part of the cost of the copyright in the software. The copyright in the software is the depreciable property, as it is listed in sch 14. If the software is developed as a series of modules that can be operated independently, each module can be depreciated as it is implemented. At that time it will be "depreciable property", and will be used or available for use in the taxpayer's business.
18. If the software is abandoned before there is an item of depreciable property, s DB 40B may allow a deduction (see from [28] below).

Research and development (R&D) expenditure

19. An alternative treatment may be available where the expenditure on software is "research" or "development" and is recognised as an expense for financial reporting purposes[1].
20. The main provision of the Act applicable to R&D expenditure is s DB 34. Section DB 34 allows a deduction for expenditure (other than expenditure excluded under s DB 34(6)) incurred on R&D by those persons who:
    - recognise the R&D expenditure as an expense for financial reporting purposes under either of two designated financial reporting standards (s DB 34(2));

[1] See *Tax Information Bulletin*, Vol 26, No 4 (May 2014) for a discussion of the relationship between the minimum financial reporting requirements for companies under the Tax Administration (Financial Statements) Order 2014 and the references to financial reporting standards in the Income Tax Act 2007.

- recognise the R&D expenditure as an expense for financial reporting purposes because it is written off as an immaterial amount but, had it been material, would have been required to recognise it as an expense for financial reporting purposes under either of the two designated financial reporting standards (s DB 34(4)); or
- incur R&D expenditure of $10,000 or less in an income year, have recognised it as an expense for financial reporting purposes (but not, necessarily, under either of the designated reporting standards) and have written the amount off as immaterial (s DB 34(5)).

21. "Research" and "development" are both defined in paragraph 8 of the New Zealand Equivalent to International Accounting Standard 38, in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place.
22. Taxpayers who incur R&D expenditure (excluding interest) can claim the deduction in the income year the expenditure is incurred or they can choose to allocate the expenditure to a later income year in accordance with s EJ 23. A deduction can only be made in a later income year if there is income that arises as a result of the R&D expenditure in that year (R&D income). A taxpayer who is eligible for a deduction under s DB 34 has the option of not taking the deduction. They have the option of returning their income and expenditure on the basis that the section does not apply (s DB 34(8)).
23. If applied, the R&D rules override the capital limitation but the general permission and other general limitations still apply (s DB 34(10)).

Post-development maintenance and upgrades

24. Expenditure incurred in maintaining software once it has been completed will generally be revenue in nature and deductible under s DA 1. This would include expenditure such as fixing programming bugs, providing help desk facilities and making minor changes to the software - that is, routine changes that do not materially increase the capacity or performance of the software.
25. Expenditure on upgrades (or improvements) to the software will be capital in nature. A change will be an upgrade when it adds new features to the software, or increases its capacity, performance or life. The cost of upgrades must be capitalised and depreciated.

Other post-development expenditure

26. The capital cost of an item includes any expenditure on installation and getting the item ready for using to earn income (see *BP Refinery (Kwinana) Ltd v FCT* (1960) 12 ATD 204 and IS 10/06 "Deductibility of business relocation costs" *Tax Information Bulletin* Vol 22, No 8 (September 2010)). Therefore, any expenditure on installing or integrating the software with the taxpayer's system will be capital.
27. Other post-development expenditure will usually be deductible under s DA 1. These costs could include, for example, producing instruction manuals and staff training.

Unsuccessful software

28. Section DB 40B overrides the capital limitation and provides a deduction for expenditure incurred on unsuccessful software development (to the extent that a deduction has not already been allowed). It only applies where the software was being developed for use in the taxpayer's **business**. The development of the software must be abandoned before the copyright in the software becomes "depreciable property". Section DB 40B also requires that the copyright in the software would have been depreciable property if the development had been completed.
29. If the requirements of s DB 40B are met, a deduction (for both the current year expenditure and the expenditure capitalised in earlier income years) is allowed in the income year in which the development of the software is abandoned.

Sale of copy of developed software

30. A taxpayer who has developed software for use in their business (and capitalised and depreciated the development costs) may also subsequently sell a copy to a third party. For example, a manufacturing business may sell a copy of the stock control software used in its business to another manufacturing business. The proceeds of the sale will be assessable income.
31. The taxpayer should continue to depreciate the development costs. If there are costs associated with producing the second copy of the software (for example, the costs of printing manuals and training materials), these will be deductible.

Commissioned software

32. Commissioned software is treated the same as software developed in-house (see from [11] above). Software commissioned by taxpayers for use in their business will be a capital asset. The costs must be capitalised until the software is complete. The costs can then be depreciated over the life of the item. The depreciation treatment is discussed in more detail below (from [35]).

33. If the development is abandoned before the software is completed, s DB 40B may apply to allow a deduction for the costs incurred. See [28] and [29] above. The treatment of post-development expenditure is the same as for software developed in-house (see from [24] above).

34. Where the expenditure on the software is "research" or "development" expenditure, s DB 34 may apply to allow an earlier deduction. See from [19] above.

Depreciation

35. Under s EE 6, for property to be depreciable, it must be property that, in normal circumstances, might reasonably be expected to decline in value while it is used (or available for use) in a business. For intangible property to be depreciable, it must also be listed in sch 14. Schedule 14 includes the copyright in software, the right to use the copyright in software, and the right to use software (such as under a licence). The property must also not be subject to any of the exclusions in s EE 7 (for example, low value property that has been dealt with under s EE 38).

36. The depreciation rate for the copyright in software, the right to use the copyright in software, and the right to use software is 50% diminishing value or 40% straight-line. An immediate write-off for software costing less than $500 will be allowed where the conditions in s EE 38 are satisfied.

37. If a taxpayer has a number of low value items of depreciable property (each item being below the maximum pooling value in s EE 65 (generally $5,000)), the taxpayer may be able to use the pool method to depreciate the group of items. The requirements for using the pool method are set out in ss EE 20 to EE 24, EE 65 and EE 66.

38. The cost of software upgrades (improvements) must be capitalised and depreciated (at 50% diminishing value or 40% straight-line). Section EE 37 sets out how improvements should be depreciated. It provides for improvements to be treated as separate items of depreciable property from the item being improved.

39. If a taxpayer believes that their particular software should have a higher or lower rate than that set by the Commissioner, the taxpayer can apply to the Commissioner for a special rate under s 91AAG of the Tax Administration Act 1994. The requirements for an application, including the associated fees, are set out in the Income Tax (Depreciation Determination) Regulations 1993. For a special rate to be given, a taxpayer needs to demonstrate that the economic life of their software is either greater or less (as the case may be) than four years (which is the economic life on which the 50% diminishing value and 40% straight line rates are based). The consequences of obtaining a special rate are set out in s EE 36.

When software disposed of or no longer used

40. Sections EE 48 to EE 52 apply where a person **receives consideration** from the disposal of an item of depreciable property in the circumstances described in ss EE 44 to EE 47. They set out how to calculate an amount of depreciation recovery income or depreciation loss and may give rise to an amount of income or deduction. Relevantly, however, ss EE 48 to EE 52 do not apply when a person disposes of an item of intangible property as part of an arrangement to replace it with an item of the same kind.

41. Section EE 39 applies when a person has an item of depreciable property (other than property that had been depreciated using the pool method) that is no longer used. Section EE 39(4) provides that a person will have an amount of depreciation loss if:

- they no longer use the item in their business, and
- neither they nor an associated person intends to use the item in deriving assessable income or carrying on a business for the purpose of deriving assessable income, and
- the costs of disposing of the item would be more than any consideration they could derive from disposing of it.

42. When the above criteria are met, a taxpayer will have an amount of depreciation loss equal to the item's adjusted tax value at the start of the income year. The taxpayer will be entitled to a deduction for this amount under s DA 1. The item's adjusted tax value at the end of the income year will then be zero.

43. Sometimes, taxpayers may not wish to or may not be able to dispose of their software when it is no longer useful. Also, sometimes, rather than being disposed of, old software may be incorporated into a new version. The Commissioner's view is that, where the software is still capable of being used by the taxpayer, it can continue to be depreciated. Where the software is incorporated into a new piece of software, the Commissioner's view is that the software is still used or available for use and can continue to be depreciated.

Lease of software under finance lease

Meaning of "finance lease"

44. "Finance lease" is defined in s YA 1:

finance lease means a lease of a personal property lease asset entered into by a person on or after 20 May 1999 that—

(a) when the person enters the lease, involves or is part of an arrangement that involves—

(i) the transfer of the ownership of the asset to the lessee or an associate of the lessee during or at the end of the term of the lease:

(ii) the lessee or an associate of the lessee having the option of acquiring the asset for an amount that is likely to be substantially lower than the asset's market value on the date of acquisition:

(iii) a right of an associate of the lessee to acquire the asset, or a right of the lessor to require an associate of the lessee to acquire the asset, during the term of the lease under an arrangement that does not entitle the associate to receive all of the personal property lease payments that may fall due after the acquisition:

(b) when the person enters the lease or from a later time, involves a term of the lease that is more than 75% of the asset's estimated useful life as defined in section EE 63 (Meaning of estimated useful life):

(c) the person enters on or after 20 June 2007 and is, or is part of, an arrangement that, when the person enters the lease or when a change in the terms of the arrangement changes the allocation or size of the risks and rewards incidental to ownership of the lease asset,—

(i) involves the use of the asset outside New Zealand for all or most of the term of the lease; and

(ii) involves income of any person who is not the lessor, arising from the use of the asset by any person, that is exempt income, or excluded income, or non-residents' foreign sourced income; and

(iii) is a finance lease under NZIAS 17 for the lessor, or for a company that is in the same group of companies as the lessor and derives assessable income from the arrangement, or is an arrangement under which persons who do not include the lessor bear substantially all the risks and rewards incidental to ownership of the lease asset, determined as at the time the person enters the lease and taking into account later changes to the arrangement

45. The term "lease" is defined in s YA 1. Relevantly, for the purposes of the finance lease provisions, it treats two or more consecutive or successive leases of the same property (to the lessee or an associate) as a single lease.

46. Therefore, a lease will be a "finance lease" if it meets the criteria in one or more of paras (a), (b), or (c) of the definition.

47. Broadly, para (a) captures arrangements where ownership of the lease asset is transferred to a lessee (or an associate), or the lessee (or an associate) has an option to acquire the lease asset for substantially below market value. It also applies where the arrangement involves a right of an associate of the lessee to acquire the asset, or a right of the lessor to require an associate of the lessee to acquire the asset, during the term of the lease where the associate is not entitled to receive all of the lease payments after the acquisition.

48. Paragraph (b) applies where, either when the person enters the lease, or at a later date, the term of the lease is greater than 75% of the asset's estimated useful life.

49. Paragraph (c) will apply less commonly. In particular, it only applies where the leased asset is used outside New Zealand for all or most of the term of the lease, and involves exempt income, excluded income or non-residents' foreign sourced income arising from the use of the asset (other than by the lessor).

Implications of having a finance lease

50. When personal property is leased under a finance lease, the lease is treated as a sale of the lease asset by the lessor to the lessee on the date on which the term of the lease starts (s FA 6). Also, the lessor is treated as giving a loan to the lessee for the lease asset and the lessee is treated as using the loan to buy the lease asset. The Act then applies to the arrangement as recharacterised.

51. As the lease is recharacterised as a sale with an associated loan, the financial arrangements rules in subpart EW apply. For the lessor, the amount of the loan is determined under s EW 32 (s FA 7(1)). For the lessee, the amount of the loan is determined under ss EW 32 and EW 33 (s FA 7(2)).

52. The depreciation rules in subpart EE also apply. The lessee is treated as the owner of the software (s FA 8(2)) and the lessor is not treated as the owner of the software. The depreciation treatment is discussed in more detail above (from [35]).

53. Where an operating lease becomes a finance lease, the lessor and lessee must both adjust their income and expenditure. Section FA 11 sets out the requirements and formula for the adjustments.

Treatment when the lease ends

54. Section FA 9 sets out the treatment at the end of a finance lease where the lessee acquires the asset. When a lessee acquires the software by the end of the lease term, the acquisition is treated as the same sale that was previously treated as occurring under s FA 6. Where the lessee (or an associate) acquires the software and later disposes of it for more than the consideration they paid, the excess is income of the lessee under s CC 11 (unless it is income under another provision of the Act). The income must be returned in the income year in which the lessee (or associated person) disposes of the asset (s FA 9(3)(a)).

55. Section FA 10 sets out the treatment where the lessor is treated as acquiring the asset at the end of the lease (because the lessee has not acquired the lease asset by the end of the lease).

Examples

56. The following examples are included to assist in explaining the application of the law.

Example 1 – periodic payments for access to online software

57. United Chemists Ltd runs a chain of pharmacies. It uses online accounting software for financial reporting, invoicing, inventory management and payroll. United Chemists pays a subscription fee of $50 per month to access the software online. United Chemists wants to know whether this fee is deductible.

58. The fee is deductible under s DA 1.

Example 2 – unsuccessful software developed in-house for use in taxpayer's business

59. Sell To Me Ltd sells household goods online. It stores the goods in five large warehouses around New Zealand. In the 2014 income year Sell To Me Ltd decided to develop some new inventory management software. It employed a computer science student (Stanley) to undertake this work and purchased a computer that was used 50% by Stanley and 50% for other business purposes.

60. Stanley works on the software for three months during a holiday break from university. In total, Sell To Me Ltd incurred expenditure of $50,000 developing the software. This amount includes Stanley's wages, 50% of the depreciation on the computer for the relevant period, and rent and utilities for the office space leased for Stanley to work in. Stanley was never able to make the software function correctly. After three months, he left Sell To Me Ltd and returned to university. In the 2015 income year, Sell To Me Ltd discovers that it is going to cost a further $50,000 to complete the software. It decides to abandon development of the software and purchase an off the shelf inventory management system instead. Sell To Me Ltd wants to know how the software development costs should be treated for income tax purposes.

61. The expenditure incurred in the 2014 is capital and cannot be deducted in that year. The expenditure is also not depreciable in the 2014 income year as there is no completed asset available to be used in the taxpayer's business. In the 2015 income year, Sell To Me Ltd decides to abandon the software. It is entitled to a deduction for all of the expenditure incurred in the development of the unsuccessful software.

Example 3 – software commissioned for use in taxpayer's business

62. In the 2013 income year, Bank With Me Ltd contracts with XYZ Software Limited to design and implement a new app to allow its customers to undertake banking transactions from their smart phones. Bank With Me will receive all rights to the app once it is complete. The software is completed in the 2015 income year. After completion, XYZ runs a two day training course for Bank With Me's staff to teach them how to use the new software. XYZ also provides ongoing maintenance services once the app is running. Bank With Me wants to know how to treat the payments that it makes to XYZ for income tax purposes.

63. The development costs incurred by Bank With Me on the app software must be capitalised until the 2015 income year when the app software is completed. At that time, it will be available for use in the taxpayer's business and the costs can be depreciated.

64. Once the app software is complete, any payments for maintenance services will be deductible when they are incurred.

65. The costs of training staff to use the app once it is complete are revenue in nature and are deductible when incurred.

Maintenance

66. A short time later, one of the major mobile phone software providers upgrades its operating system. Bank With Me's app will not run on the upgraded system so Bank With Me hires XYZ Software again to make the relatively minor modifications required so that the software will run on the new operating system. At the same time, XYZ Software also fixes a number of minor bugs. Bank With Me wants to know whether the costs of the changes should be treated as capital or revenue.

67. The changes to Bank With Me's app are revenue and can be deducted when incurred. As operating system software is upgraded relatively frequently, making modifications to software so that it can run on the upgraded system is more in the nature of maintenance rather than an upgrade. The changes do not add any new functionality as such. Rather they allow the app to continue to run consistently with its original specifications. The fact that a few minor bugs were fixed at the same time does not change this conclusion.

Upgrade

68. The following year, Bank With Me decides to make some modifications to the app to allow users to make payments directly to other app users via Bluetooth. Bank With Me again hires XYZ Software to make the changes.

69. The change adds a material new function to the software and, as such, is an upgrade and should be capitalised and depreciated in accordance with s EE 37.

Example 4 – allocation of indirect costs for in-house developer

70. XYZ Insurance Ltd has an in-house operation which develops software for use in the insurance company's business. In the last income year the software development operation worked on one major project and spent the rest of the time on maintenance work for existing software.

71. The in-house operation employs two staff for software development and maintenance work. Each staff member works 1,000 hours a year.

	Project Development work (hours)	**Maintenance work (hours)**	**Total**
Jack	800	200	1,000
Jill	600	400	1,000
Total	1,400	600	2,000

Indirect overhead costs allocated to software development operation for income year: $100,000

Allocation of indirect overhead to project:

Total hours worked	=	2,000 hours
Proportion of hours worked for project	=	1,400 ÷ 2,000
	=	0.7
Indirect overhead costs of project	=	$100,000 × 0.7
	=	$70,000

72. Therefore, besides the direct costs of the project, XYZ Insurance Ltd must capitalise an additional $70,000 of indirect overhead cost for the project. When the development is completed capitalised costs will be deductible under the depreciation regime.

Example 5 – software still undergoing testing

73. XYZ Accounting Ltd is a large national accounting firm. It commissions Brittany to develop a new document management system.

74. At the end of April, Brittany completes the initial development and the software is operational. During May and June the software undergoes extensive testing by two of XYZ Accounting's staff members. During this time a number of issues are identified that require further development. In July, Brittany completed the required changes. A final testing phase is carried out in August. On 1 September it is determined that the software is ready to go live. The actual rollout to all staff occurs on 1 October. A number of minor bugs are identified and Brittany fixes these on 1 November.

75. XYZ Accounting wants to know when it can start depreciating the software. The software was available for use in the taxpayer's business from 1 September and can be depreciated from this date. Prior to this the software was not available for use as it was still being tested and it had not been determined that it could be used as intended. It is not necessary for XYZ Accounting to wait until the software is actually rolled out for use by staff (as long as it is capable of being used). Nor does it matter that the software still contains some minor bugs.

References

Related rulings/statements

IG0007 "Non-resident software suppliers' payments derived from New Zealand – Income tax treatment" *Tax Information Bulletin* Vol 15, No 11 (November 2003)

"Income Tax Treatment of Computer Software" Appendix to *Tax Information Bulletin* Vol 4, No 10 (May 1993)

IS 17/01: "Income Tax – Deductibility of Feasibility Expenditure" (*Tax Information Bulletin* Vol 28, No. 3 (April 2017))

IS 10/06 "Deductibility of business relocation costs" *Tax Information Bulletin* Vol 22, No 8 (September 2010)

Subject references

Abandoned software
Depreciation
Income Tax
Licence
Software
Unsuccessful software

Case references

BP Refinery (Kwinana) Ltd v FCT (1960) 12 ATD 204

Legislative references

Income Tax Act 2007: ss DA 1, DA 2, DB 40B, EE 6, EE 7, EE 18B, EE 36, EE 37, EE 38, EE 39, EE 44 – 47, EE 48 – 52, EE 65, EE 66, subpart FA, sch 14

Tax Administration Act 1994: s 91AAG

Appendix: Legislation

1. Sections DA 1 and DA 2 state:

DA 1 General Permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

(2) Subsection (1) is called the **general permission**.

Avoidance arrangements

(3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

…

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

2. Section DB 34 states:

DB 34 Research or development

Deduction

(1) A person is allowed a deduction for expenditure they incur on research or development. This subsection applies only to a person described in any of subsections (2) to (5) and does not apply to the expenditure described in subsection (6).

Person recognising expenditure as expense

(2) Subsection (1) applies to a person who recognises the expenditure as an expense for financial reporting purposes-

(a) under paragraph 5.1 or 5.2 of the old reporting standard or because paragraph 5.4 of that standard applies; or

(b) under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard.

Expenditure on derecognised non-depreciable assets

(3) Subsection (1) applies to a person who—

(a) incurs expenditure, on the development of an intangible asset that is not depreciable intangible property,—

(i) on or after 7 November 2013; and

(ii) before the intangible asset is derecognised or written off by the person as described in paragraph (b); and

(b) derecognises or writes off the intangible asset for financial reporting purposes under—

(i) paragraph 112(b) of the new reporting standard; or

(ii) paragraph 5.14 of the old reporting standard.

Person recognising expenditure otherwise

(4) Subsection (1) also applies to a person who—

(a) recognises the expenditure as an expense for financial reporting purposes because it is an amount written off as an immaterial amount for financial reporting purposes; and

(b) would be required, if the expenditure were material, to recognise it for financial reporting purposes-

(i) under paragraph 5.1 or 5.2 of the old reporting standard or because paragraph 5.4 of that standard applies; or

(ii) under paragraph 68(a) of the new reporting standard applying, for the purposes of that paragraph, paragraphs 54 to 67 of that standard.

Person with minor expenditure

(5) Subsection (1) also applies to a person who—

(a) incurs expenditure of $10,000 or less, in total, on research and development in an income year; and

(b) has written off the expenditure as an immaterial amount for financial reporting purposes; and

(c) has recognised the expenditure as an expense for financial reporting purposes.

Exclusion

(6) Subsection (1) does not apply to expenditure that the person incurs on property to which all the following apply:

(a) the property is used in carrying out research or development; and

(b) it is not created from the research or development; and

(c) it is 1 of the following kinds:

(i) property for which the person is allowed a deduction for an amount of depreciation loss; or

(ii) property the cost of which is allowed as a deduction by way of amortisation under a provision of this Act outside subpart EE (Depreciation); or

(iii) land; or

(iv) intangible property, other than depreciable intangible property; or

(v) property that its owner chooses, under section EE 8 (Election that property not be depreciable) to treat as not depreciable.

Choice for allocation of deduction

(7) A person who is allowed a deduction under this section for expenditure that is not interest and is described in subsection (2), (4), or (5) may choose to allocate all or part of the deduction—

(a) to an income year after the income year in which the person incurs the expenditure; and

(b) in the way required by section EJ 23 (Allocation of deductions for research, development, and resulting market development).

Allocation of deduction for derecognised non-depreciable assets

(7B) A person who is allowed a deduction as provided by subsection (3) must allocate the deduction to the income year in which the relevant intangible asset is derecognised or written off by the person for financial reporting purposes under—

(a) paragraph 112(b) of the new reporting standard; or

(b) paragraph 5.14 of the old reporting standard.

Section need not be applied

(8) A person may return income and expenditure in their return of income on the basis that this section does not apply to expenditure incurred on research or development in the income year to which the return relates.

Relationship with section EA 2

(9) If expenditure to which this section applies is incurred in devising an invention that is patented, the expenditure is not treated as part of the cost of revenue account property for the purposes of section EA 2 (Other revenue account property).

Link with subpart DA

(10) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

3. Section DB 35 defines the following terms:

development is defined in paragraph 8 of the new reporting standard

new reporting standard means the New Zealand Equivalent to International Accounting Standard 38, in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place

old reporting standard means Financial Reporting Standard No 13 1995 (Accounting for Research and Development Activities) being the standard approved under the Financial Reporting Act 1993, or an equivalent standard issued in its place, that applies in the tax year in which the expenditure is incurred

research is defined in paragraph 8 of the new reporting standard.

4. Section DB 40B states:

DB 40B Expenditure in unsuccessful development of software

When this section applies

(1) This section applies when a person incurs expenditure in the development of software for use in the person's business if—

(a) the development of the software is abandoned when the software is not depreciable property of the person; and

(b) the software would have been depreciable property of the person if the development had been completed.

Deduction

(2) The person is allowed a deduction for expenditure incurred in the development of the software to the extent to which no deduction has been allowed for the expenditure under another provision of this Act or under another Act.

Timing of deduction

(3) The deduction is allocated to the income year in which the development of the software is abandoned.

Link with subpart DA

(4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

5. The relevant provisions from subpart EE state:

EE 6 What is depreciable property?

Description

(1) Depreciable property is property that, in normal circumstances, might reasonably be expected to decline in value while it is used or available for use—

(a) in deriving assessable income; or

(b) in carrying on a business for the purpose of deriving assessable income.

Subsections (2) to (4) expand on this subsection.

Property: tangible

(2) An item of tangible property is depreciable property if—

(a) it is described by subsection (1); and

(b) it is not described by section EE 7.

Property: intangible

(3) An item of intangible property is depreciable property if—

(a) it is within the definition of **depreciable intangible property**; and

(b) it is described by subsection (1); and

(c) it is not described by section EE 7.

…

EE 7 What is not depreciable property?

The following property is not **depreciable property**:

(a) land other than depreciable intangible property, although buildings, fixtures, and the improvements listed in schedule 13 (Depreciable land improvements) are depreciable property if they are described by section EE 6(1):

(ab) a lease of land with a perpetual right of renewal:

(b) trading stock:

(c) livestock to which subpart EC (Valuation of livestock)) applies:

(d) financial arrangements:

(e) excepted financial arrangements other than depreciable intangible property:

(f) property that will not decline in value, as far as its owner is concerned, because, when they dispose of it, they have a right to be compensated for any decline in its value:

(g) property that its owner chooses, under section EE 8, to treat as not depreciable:

(h) property that its owner chooses, under section EE 38, to deal with under that section:

(i) property for whose cost a person other than the property's owner is allowed a deduction:

(j) property for whose cost a person is allowed a deduction under a provision of this Act outside this subpart or under a provision of an earlier Act, except for an asset to which section DU 6(4) (Depreciation) applies.

EE 18B Cost: some depreciable intangible property

For the purposes of section EE 16 and this subpart, the cost to a person for an item of depreciable intangible property or a plant variety rights application (the **amortising item**) includes an amount of expenditure incurred by the person for an item of intangible property (the **underlying item**) if—

(a) the underlying item gives rise to, supports, or is an item in which the person holds, the amortising item; and

(b) the amount of expenditure is incurred by the person on or after 7 November 2013, if the amortising item is 1 of—

(i) a patent or a patent application with a complete specification lodged on or after 1 April 2005:

(ii) plant variety rights:

(iii) a plant variety rights application:

(iv) a design registration:

(v) a design registration application:

(vi) industrial artistic copyright; and

(c) the person is denied a deduction for the expenditure under a provision outside this subpart.

EE 36 Using economic rate or provisional rate instead of special rate

Allowed to use economic or provisional rate

(1) A person may depreciate an item to which a special rate applies by applying, instead, the economic rate applicable to the item or a provisional rate applicable to the item. This subsection is overridden by subsection (2)

Not allowed to use economic or provisional rate

(2) The person must not depreciate the item by applying the economic rate or the provisional rate, if—

(a) a special rate applies to the item; and

(b) the special rate is higher than the economic rate; and

(c) the person applies the special rate to the item for an income year; and

(d) in a later income year, the item's market value declines at a rate equal to or greater than the special rate; and

(e) it is a reasonable conclusion from all the circumstances of the case that the person's purpose, or 1 of the person's purposes, in wanting to change from the special rate to the economic rate or the provisional rate for the later income year is to enable the person to defer the deduction that the person is allowed for the amount of depreciation loss for the item's decline in value.

EE 37 Improvements

When this section applies

(1) This section applies when a person makes an improvement to an item of depreciable property.

Income year in which improvement made

(2) In the income year in which the person makes the improvement, the provisions of this subpart apply to the improvement, as if it were a separate item of depreciable property, in the period that—

(a) starts at the start of the month in which the person first uses the improvement or has it available for use; and

(b) ends at the end of the income year.

Following income years

(3) For income years following the income year in which the person makes the improvement,—

(a) a person who uses the diminishing value method or the straight-line method for the item that was improved may choose to apply subsection (4) or (5), if paragraph (ab) does not apply:

(ab) a person who uses the diminishing value method or the straight-line method for the item that was improved must use subsection (3B) if—

(i) treating the improvement as an item, section EE 31(2A) does not apply, but section EE 31(3A) does apply; and

(ii) the item that was improved is a grandparented structure, or is not a building, is not a used import car, is not an international aircraft, or has not been used or held for use in New Zealand as an item of depreciable property before the date on which the person acquires it:

(b) a person who uses the pool method for the item that was improved must apply subsections (6) and (7).

Improvement compulsorily treated as separate item

(3B) For the purposes of subsection (3)(ab), a person must treat the improvement as a separate item of depreciable property.

Improvement treated as separate item

(4) For the purposes of subsection (3)(a), a person may choose to treat the improvement as a separate item of depreciable property.

Improvement treated as part of item

(5) For the purposes of subsection (3)(a), a person may choose to treat the improvement as part of the item of depreciable property that was improved. They must do 1 of the following for the first income year, after the income year in which they made the improvement, in which they use the improvement or have it available for use:

(a) if they use the diminishing value method for the item, add the improvement's adjusted tax value at the start of the income year to the item's adjusted tax value at the start of the income year:

(b) if they use the straight-line method for the item,—

(i) add the improvement's adjusted tax value at the start of the income year to the item's adjusted tax value at the start of the income year; and

(ii) add the improvement's cost to the item's cost.

Pool method

(6) For the purposes of subsection (3)(b), a person who uses the pool method for the item that was improved must treat the improvement as a separate item of depreciable property. If its cost is equal to or less than its maximum pooling value, they must include it in a pool in the first income year, after the income year in which they made the improvement, in which they use the improvement or have it available for use.

Adjustment of pool's value

(7) When an improvement is included in a pool under subsection (6),—

(a) the pool's adjusted tax value is increased by the improvement's adjusted tax value on the date it is included in the pool; and

(b) the improvement's adjusted tax value at the end of the previous income year is included in **starting adjusted tax value** in section EE 21(5).

EE 39 Items no longer used

When this section applies

(1) This section applies when a person in an income year has an item of depreciable property that—

(a) is no longer used or, because the geothermal energy proving period has ended, becomes unavailable for use under section EE 6(4); and

(b) is not a building, unless the item meets the requirements of subsection (2); and

(c) has not been depreciated using the pool method.

…

Amount of depreciation loss under this section

(3) The person has an amount of depreciation loss under this section and under no other provision of this subpart.

Circumstances

(4) The person has an amount of depreciation loss if—

(a) they no longer use the item in deriving assessable income or carrying on a business for the purpose of deriving assessable income; and

(b) neither they nor a person associated with them intends to use the item in deriving assessable income or carrying on a business for the purpose of deriving assessable income; and

(c) the costs of disposing of the item would be more than any consideration they could derive from disposing of it.

Amount

(5) The amount of depreciation loss is the item's adjusted tax value at the start of the income year.

Adjusted tax value at end of year

(6) The item's adjusted tax value at the end of the income year is zero.

EE 44 Application of sections EE 48 to EE 52

When sections apply

(1) Sections EE 48 to EE 52 apply when a person has consideration from the disposal of an item or from an event involving an item, if—

- (a) the consideration is consideration of a kind described in section EE 45; and
- (b) either—
  - (i) the item is an item of a kind described in section EE 46; or
  - (ii) the event is an event of a kind described in section EE 47.

Exclusions

(2) Sections EE 48 to EE 52 do not apply when—

- (a) a person disposes of an item of intangible property as part of an arrangement to replace it with an item of the same kind:
- (b) a person's patent application has concluded because a patent is granted to the person in relation to the application:
- (c) a person's geothermal well becomes unavailable for use under section EE 6(4) because the geothermal energy proving period has ended:
- (d) a person receives, for an item of property, an amount of insurance to which section EZ 23B (Property acquired after depreciable property affected by Canterbury earthquakes) applies.

EE 45 Consideration for purposes of section EE 44

General rule

(1) For the purposes of section EE 44, the **consideration** equals the amount that a person derives excluding any GST charged if the person is a registered person, as modified by subsections (3) to (11) minus the amount (the **disposal cost**) that they incur in deriving that amount, to the extent to which the disposal cost—

- (a) is not allowed as a deduction to the person other than as a deduction for an amount of depreciation loss; and
- (b) is not counted in "the amount that a person derives".

GST for disposal costs

(1B) All amounts deducted or deductible by the person under section 20(3) of the Goods and Services Tax Act 1985 in relation to the disposal cost described in subsection (1) are subtracted from the disposal costs under that subsection.

Consideration may be zero or negative

(2) For the purposes of section EE 44, the **consideration** may be zero or a negative amount.

Other than market value

(3) If the person has consideration that is not the item's market value, the amount that the person derives is the item's market value. Three qualifications are—

- (a) if the person makes a taxable supply, "market value" means the market value minus any GST that would be charged on the supply:
- (b) this subsection does not apply to a transfer under a relationship agreement; and
- (c) this subsection does not apply in a case described in any of subsections (5) to (10).

Relationship with subpart FC

(4) Subsection (3) does not apply to a disposal of property to which any of sections FC 3 and FC 4 (which relate to the distribution or transmission of property) applies.

Change of use or location of use

(5) The consideration that a person derives from the event described in section EE 47(2) is the item's market value. Two qualifications are—

- (a) if the person makes a taxable supply, "market value" means the market value minus any GST that would be charged on the supply:
- (b) this subsection does not apply to a transfer under a relationship agreement.

Loss or theft

(6) The amount that a person derives from the event described in section EE 47(3) is the amount of insurance, indemnity, or compensation they receive for the loss or theft (**amount A**). If the person is a registered person, amount A does not include the amount, if any, of GST charged on amount A to the extent to which amount A is treated as being consideration received for a supply of services by the registered person under section 5(13) of the Goods and Services Tax Act 1985.

…

Repossession

(9) The amount that a person derives from the event described in section EE 47(5) is the item's cost minus the net amount paid. Two qualifications are—

(a) if the person is a registered person, the "amount that a person derives" does not include any GST charged on a taxable supply they make:

(b) "net amount paid" means the amount paid by the buyer to the seller for the item under the contract minus any amount refunded by the seller to the buyer.

Other items

(10) The amount that a person derives from the disposal of an item along with any other item, or from the occurrence of an event involving an item that also involves other items, is the item's market value. Two qualifications are—

(a) if the person makes a taxable supply, "market value" means the market value minus any GST that would be charged on the supply:

(b) this subsection does not apply to a transfer under a relationship agreement.

Item leaving New Zealand permanently

(11) The amount that a person derives from the event referred to in section EE 47(10) is described in section EZ 21(1) (Sections EE 45 and EE 47: permanent removal: allowance before 1 April 1995).

EE 46 Items for purposes of section EE 44

Items to which sections EE 48 to EE 52 apply

(1) For the purposes of section EE 44, an item of property to which sections EE 48 to EE 52 apply is an item of depreciable property that a person owns, including—

(a) an item for which the person has been allowed a deduction for an amount of depreciation loss they have had under section EE 33; and

(b) an item to which section CZ 11 (Recovery of deductions for software acquired before 1 April 1993) applies.

Exclusions

(2) Sections EE 48 to EE 52 do not apply to—

(a) an item of property that, on the date on which the disposal or the event occurs, is accounted for in a pool; or

(b) an item of petroleum-related depreciable property; or

(c) an item of intangible property that is excluded depreciable property, other than software; or

(d) a land improvement that is excluded depreciable property of a kind for which no deduction for depreciation was allowed under section 108 of the Income Tax Act 1976.

EE 47 Events for purposes of section EE 44

Events to which sections EE 48 to EE 52 apply

(1) For the purposes of section EE 44, this section describes the events to which sections EE 48 to EE 52 apply.

Change of use or location of use

(2) The first event is the change of use, or change of location of use, of an item of property, as a result of which a person is denied a deduction for an amount of depreciation loss for the item for the next income year. The event is treated as occurring on the first day of the next income year, and includes a change in use of an item for the purposes of the definition of commercial fit-out and a change in the status of a building related to an item for the purposes of that definition.

Loss or theft

(3) The second event is the loss or theft of an item of property, if the item is not recovered in the income year in which the loss or theft occurs.

Irreparable damage or damage rendering building or grandparented structure useless

(4) The third event is—

(a) the irreparable damage of an item of property that is not a building or grandparented structure; or

(b) the damage of an item of property that is a building or grandparented structure, or of the neighbourhood of the building or grandparented structure, causing the building or grandparented structure to be—

(i) useless for the purpose of deriving income; and

(ii) demolished or abandoned for later demolition.

Repossession

(5) The fourth event is the seller's repossession of an item of property to which section EE 3 applies because the buyer wholly or partly fails to pay the consideration. The event is treated as occurring on the date on which the item is repossessed.

Unused geothermal well brought into use

(6) The fifth event is, for a person's geothermal well that is unavailable for use under section EE 6(4) because the geothermal energy proving period has ended, is when the person starts to—

(a) use the well in deriving assessable income or carrying on a business for the purpose of deriving assessable income:

(b) have the well available for use in deriving assessable income or carrying on a business for the purpose of deriving assessable income.

Statutory acquisition

(7) The sixth event is the acquisition of an item of property by a person acting under statutory authority.

Cessation of ownership under section EE 4 or EE 5

(8) The seventh event is the cessation of ownership of a fixture or improvement—

(a) that a lessee is treated as having under section EE 4(2); or

(b) that a person is treated as having under section EE 5(3).

Cessation of rights in intangible property

(9) The eighth event is an occurrence that has the effect that the owner of an item of intangible property is no longer able, and will never be able, to exercise the rights that constitute or are part of the item.

Item leaving New Zealand permanently

(10) The ninth event is described in section EZ 21(2) (Sections EE 45 and EE 47: permanent removal: allowance before 1 April 1995).

EE 48 Effect of disposal or event

Amount of depreciation recovery income

(1) For the purposes of section EE 44, if the consideration is more than the item's adjusted tax value on the date on which the disposal or the event occurs, the lesser of the following amounts is the amount of depreciation recovery income derived by the person:

(a) the amount by which the consideration is more than the item's adjusted tax value on the date on which the disposal or the event occurs; and

(b) the amount given by subsections (1B) and (1C).

Amount for subsection (1)(b)

(1B) The amount for the purposes of subsection (1)(b) is given by the following formula:

item depreciation loss + CZ 11 item amount + DB 64 item amount.

Definition of items in formula

(1C) In the formula in subsection (1B),—

(a) **item depreciation loss** is the total of the amounts of depreciation loss for which the person has been allowed deductions for the item:

(b) **CZ 11 item amount** is the amount of any deduction allowed for the acquisition of the item, for the person, if the item is one to which section CZ 11 (Recovery of deductions for software acquired before 1 April 1993) applies:

(c) **DB 64 item amount** is the amount of the capital contribution for the item, for the person, if the item is one to which section DB 64 (Capital contributions) applies.

Amount of depreciation loss

(2) For the purposes of section EE 44, if the consideration is less than the item's adjusted tax value on the date on which the disposal or the event occurs, the person has an amount of depreciation loss that is the amount by which the consideration is less than the item's adjusted tax value on that date.

Income year of depreciation recovery income

(2B) The person derives the depreciation recovery income in the income year that is the earliest income year in which the consideration can be reasonably estimated.

When subsection (2) does not apply

(3) Subsection (2) does not apply if the item is a building unless—

(a) the building or grandparented structure has been rendered useless for the purpose of deriving income, and demolished or abandoned for later demolition as a result of damage to the building or grandparented structure or of the neighbourhood of the building or grandparented structure; and

(b) *[Repealed]*

(c) the damage is caused—

(i) by a natural event not under the control of the person, an agent of the person, or an associated person; and

(ii) other than as a result of the action or failure to act of the person, an agent of the person, or an associated person.

EE 49 Amount of depreciation recovery income when item partly used for business

Item to which this section applies

(1) This section applies to an item of property that—

(a) is an item to which this section applies, as described in section EE 46; and

(b) is, at any time during the period the person owns it, dealt with in—

(i) subpart DE (Motor vehicle expenditure); or

(ii) any applicable paragraph in section EZ 11 (Amounts of depreciation recovery income and depreciation loss for part business use up to 2004–05 income year); or

(iii) section EE 50.

Depreciation recovery income

(2) If the consideration referred to in section EE 44 is less than or equal to the cost of the item to the person, the amount of depreciation recovery income that the person has is an amount calculated using the formula in subsection (3).

Formula

(3) The formula is—

(all deductions ÷ (base value – adjusted tax value)) × amount of depreciation recovery income

Definition of items in formula

(4) The items in the formula are defined in subsections (5) to (8).

All deductions

(5) **All deductions** is all amounts of depreciation loss for which the person has been allowed a deduction for the item in each of the income years in which the person has owned the item.

Base value

(6) **Base value** has the applicable one of the meanings in sections EE 57 to EE 59.

Adjusted tax value

(7) **Adjusted tax value** is the item's adjusted tax value on the date on which the disposal or the event occurs.

Amount of depreciation recovery income

(8) **Amount of depreciation recovery** income is the amount described in section EE 48(1).

EE 50 Amount of depreciation loss when item partly used to produce income

When subsection (2) applies

(1) Subsection (2) applies when—

(a) a person has an amount of depreciation loss for an item of depreciable property for an income year, other than an amount arising under section EE 48(2); and

(b) at a time during the income year, the item is partly used, or partly available for use, by the person—

(i) in deriving assessable income or carrying on a business for the purpose of deriving assessable income; or

(ii) in a way that is subject to fringe benefit tax; and

(c) at the same time, the item is partly used, or is partly available for use, by the person for a use that falls outside both paragraph (b)(i) and (ii); and

(d) the item is not a motor vehicle to which subpart DE (Motor vehicle expenditure) applies.

Partial use: formula

(2) The deduction the person is allowed for the amount of depreciation loss must not be more than the amount calculated using the formula—

depreciation loss × qualifying use of days ÷ all days

Definition of items in formula

(3) In the formula in subsection (2),—

(a) **depreciation loss** is the amount of depreciation loss for the income year:

(b) **qualifying use days** is the number of days in the income year on which the person owns the item and uses it, or has it available for use, for a use that falls within subsection (1)(b)(i) or (ii):

(c) **all days** is the number of days in the income year on which the person owns the item and uses it or has it available for use.

Other units of measurement

(4) A unit of measurement other than days, whether relating to time, distance, or anything else, is to be used in the formula if it achieves a more appropriate apportionment.

When subsection (6) applies

(5) Subsection (6) applies when—

(a) a person has an amount of depreciation loss for an item of depreciable property arising under section EE 48(2); and

(b) the item was, at any time during the period the person owned it, dealt with in—

(i) subsection (2); or

(ii) any applicable paragraph in section EZ 11 (Amounts of depreciation recovery income and depreciation loss for part business use up to 2004–05 income year); and

(d) the item is not a motor vehicle to which subpart DE applies.

Deduction for depreciation loss: formula

(6) The deduction the person is allowed for the amount of depreciation loss is calculated using the formula—

disposal depreciation loss x all deductions ÷ (base value – adjusted tax value at date)

Definition of items in formula

(7) In the formula in subsection (6),—

(a) **disposal depreciation loss** is the amount resulting from a calculation made for the item under section EE 48(2):

(b) **all deductions** is all amounts of depreciation loss relating to the item for which the person has been allowed a deduction in each of the income years in which the person has owned the item:

(c) **base value** has whichever is applicable of the meanings in sections EE 57 to EE 59:

(d) **adjusted tax value at date** is the item's adjusted tax value on the date on which the disposal or event occurs.

When subsection (9) applies

(8) Subsection (9) applies when—

(a) a person has an amount of depreciation loss for an item of depreciable property for an income year arising under section EE 48(2); and

(b) in the income year in which the amount of depreciation loss arises, the person starts to use the item, or have it available for use, for the purpose of deriving assessable income or carrying on a business for the purpose of deriving assessable income; and

(c) at a time during the income year, the item is partly used, or partly available for use, by the person—

(i) in deriving assessable income or carrying on a business for the purpose of deriving assessable income; or

(ii) in a way that is subject to fringe benefit tax; and

(d) the item is not a motor vehicle to which subpart DE (Motor vehicle expenditure) applies.

Partial use: formula

(9) The deduction the person is allowed for the amount of depreciation loss is calculated using the formula—

disposal depreciation loss × qualifying use days ÷ all days

Definition of items in formula

(10) In the formula in subsection (9),—

(a) **disposal depreciation loss** is the amount resulting from a calculation made for the item under section EE 48(2):

(b) **qualifying use days** is the number of days in the income year on which the person owns the item and uses it, or has it available for use, for a use that falls within subsection (8)(c)(i) or (ii):

(c) **all days** is the number of days in the income year on which the person owns the item and uses it or has it available for use for any purpose.

Other units of measurement

(11) A unit of measurement other than days, whether relating to time, distance, or anything else, is to be used in the formula if it achieves a more appropriate apportionment.

EE 51 Amount of depreciation recovery income when lost or stolen items recovered

When this section applies

(1) This section applies when an item of property to which section EE 47(3) applies—

(a) is recovered in a later income year; and

(b) is still owned by the person; and

(c) is still used or available for use by the person.

Person treated as acquiring item

(2) The person is treated as having acquired the item, on the date of recovery, for its adjusted tax value at the start of the income year in which it was lost or stolen.

Person treated as deriving income: amount

(3) The person is treated as deriving an amount of depreciation recovery income equal to the amount of depreciation loss that the person has under section EE 48(2) for which they have been allowed a deduction.

Person treated as deriving income: income year

(4) The income year in which the person derives the depreciation recovery income is—

(a) the income year in which the item is lost or stolen, if the person chooses that year; or

(b) the income year in which the item is recovered, in any other case.

EE 52 Amount of depreciation recovery income when compensation received

When this section applies

(1) This section applies when a person receives insurance, indemnity, or compensation for an item of property to which this section applies, as described in section EE 46, other than for an item that is lost, stolen, or irreparably damaged.

Compensation subtracted

(2) An amount must be subtracted from the item's adjusted tax value. The amount is the amount by which the insurance, indemnity, or compensation that the person receives is more than the expenditure that the person incurs because of the event for which the person receives the insurance, indemnity, or compensation.

Depreciation recovery income

(3) If the item's adjusted tax value becomes negative in an income year through the application of subsection (2), the negative amount is an amount of depreciation recovery income derived by the person in the income year.

Compensation derived when item no longer owned

(4) If, in the absence of this subsection, the person would derive the amount of insurance, indemnity, or compensation after ceasing to own the item, the person is treated as deriving the amount immediately before the person ceases to own the item.

EE 65 Meaning of maximum pooling value

Meaning

(1) Maximum pooling value, for an item of depreciable property, means the greater of—

(a) $5,000; and

(b) the value set in a determination issued under section 91AAL of the Tax Administration Act 1994 applying to the item.

Increase in specified sum

(2) The Governor-General may make an Order in Council increasing the sum specified in subsection (1)(a).

EE 66 Meaning of poolable property

Meaning

(1) **Poolable property**, for an income year, means an item of depreciable property that a person owns to which subsections (2) to (4) apply.

Not a building

(2) The item is not a building.

Maximum pooling value or globo method

(3) The item—

(a) is acquired in the income year for a cost equal to or less than its maximum pooling value; or

(b) was previously accounted for separately but has, as at the start of the income year, an adjusted tax value equal to or less than its maximum pooling value; or

(c) was accounted for at the end of the 1992–93 income year using, with the Commissioner's permission, the globo accounting method.

Wholly used or subject to fringe benefit tax

(4) The item—

(a) is wholly used or available for use by the person in deriving assessable income or carrying on a business for the purpose of deriving assessable income; or

(b) to the extent to which it is not wholly used or available for use by the person in deriving assessable income or carrying on a business for the purpose of deriving assessable income, is used in a way that is subject to fringe benefit tax.

6. Section EJ 23 states:

EJ 23 Allocation of deductions for research, development, and resulting market development

When this section applies

(1) This section applies when a person has—

(a) a deduction for expenditure incurred on research or development that the person chooses to allocate under section DB 34(7) (Research or development):

(b) a deduction for an amount of depreciation loss for an item used for research or development, that the person chooses to allocate under section EE 1(5) (What this subpart does):

(c) a deduction for expenditure incurred on market development for a product that has resulted from expenditure incurred on research or development that the person chooses to allocate under section EJ 22(2).

Timing of deduction

(2) The person must allocate the deduction to an income year—

(a) in which the person derives an amount of income that is assessable income that the person would not have derived but for—

(i) expenditure that gives rise to a deduction that may be allocated under this section:

(ii) the use or disposal of an item for which the person has an amount of depreciation loss that may be allocated under this section:

(b) to which under Part I (Treatment of tax losses) a loss balance is carried forward for the income year in which the expenditure or depreciation loss was incurred.

Minimum amount of deduction allocated to income year

(3) The person must not allocate to an income year (the current year) an amount of deductions referred to in subsection (1) that is less than the lesser of—

(a) the amount of assessable income referred to in subsection (2)(a) that the person derives in the current year:

(b) the amount of the deductions that have not been allocated to an income year before the current year.

Maximum amount of deduction allocated to income year

(4) The person must not allocate to an income year (the current year) an amount of deductions referred to in subsection (1) that is more than the greater of—

(a) the amount of assessable income referred to in subsection (2)(a) that the person derives in the current year:

(b) the amount of the deductions that—

(i) arise in other income years from which a loss balance may be carried forward under Part I to the current year; and

(ii) have not been allocated to income years before the current year.

7. The relevant provisions from subpart FA state:

FA 6 Recharacterisation of amounts derived under finance leases

When a personal property lease asset is leased under a finance lease, the lease is treated as a sale of the lease asset by the lessor to the lessee on the date on which the term of the lease starts, and—

(a) the lessor is treated as giving a loan to the lessee for the lease asset; and

(b) the lessee is treated as using the loan to buy the lease asset; and

(c) subpart EE (Depreciation), the financial arrangements rules, and the other provisions of this Act apply to the arrangement as recharacterised.

FA 7 Determining amount of loan

Value to lessor

(1) For a lessor under a finance lease, the amount of the loan is determined under section EW 32 (Consideration for agreement for sale and purchase of property or services, hire purchase agreement, specified option, or finance lease).

Value to lessee

(2) For a lessee under a finance lease, the amount of the loan is determined under sections EW 32 and EW 33 (which relate to the value of consideration under the financial arrangements rules).

FA 8 Deductibility of expenditure under finance lease

Lessee treated as owner

(1) The lessee under a finance lease is treated as the owner of the personal property lease asset for the purposes of subpart EE (Depreciation).

Lessor not treated as owner

(2) The lessor under a finance lease is not treated as the owner of the personal property lease asset for the purposes of subpart EE.

FA 9 Treatment when lease ends: lessee acquiring asset

Acquisition treated as sale

(1) When a lessee under a finance lease acquires the personal property lease asset by the date on which the term of the lease ends, the acquisition is treated as the same sale that is treated as occurring under section FA 6.

When lessee or associated person acquires lease asset and later disposes of it

(2) If a lessee under a finance lease, or a person associated with them, acquires the lease asset and later disposes of it for an amount that is more than the consideration they paid for it, the excess is income of the lessee under section CC 11 (Lessee acquiring lease asset on expiry of term of lease).

Allocation and association

(3) For the purposes of subsection (2),—

(a) the excess is income of the lessee in the income year in which the lessee or associated person disposes of the asset:

(b) association is determined at the time of acquisition by the associated person.

Exception

(4) Subsection (2) does not apply if the consideration derived on the disposal is income of the lessee or an associated person under a provision of this Act other than this section.

FA 10 Treatment when lease ends: lessor acquiring asset

When this section applies

(1) This section applies when a finance lease ends by the date on which its term ends.

Acquisition by lessor at end of lease

(2) If the lessee does not acquire the personal property lease asset by the date on which the term of the lease ends, the lessor is treated as having acquired it on that date at its guaranteed residual value. If there is no guaranteed residual value, the consideration is treated as zero. In this section, the consideration is called the **notional sale price**.

Further sale, assignment, or lease

(3) Subsections (4) and (5) apply when the lessor sells, assigns, or leases the lease asset to another person under another finance lease on or after the date on which the term of the original lease ends.

When consideration more than notional sale price

(4) If the consideration is more than the notional sale price,—

(a) to the extent to which it is paid by the lessor to the lessee under the original finance lease, the notional sale price is increased by the amount of the difference; and

(b) to the extent to which it is not paid by the lessor to the lessee under the original finance lease, the amount of the difference is income of the lessor under section CC 12 (Lessor acquiring lease asset on expiry of term of lease) in the income year in which the original lease term ends.

When consideration less than notional sale price

(5) If the consideration is less than the notional sale price, and the lessee is required to pay the amount of the deficit to the lessor, the notional sale price is reduced by that amount.

Acquisition by lessor when lease ends early

(6) If the lease is terminated before the end of its term and the lessee does not acquire the lease asset, the lessor is treated as acquiring it for an amount calculated using the formula—

outstanding balance − release payment.

Definition of items in formula

(7) In the formula,—

(a) **outstanding balance** is the amount of the outstanding balance of the loan on the date on which the lease is terminated:

(b) **release payment** is the amount the lessee paid to be released from their obligations under the lease.

Relationship with section EE 45

(8) Subsections (2) to (6) override section EE 45 (Consideration for purposes of section EE 44).

FA 11 Adjustments for leases that become finance leases

When this section applies

(1) This section applies when a lease is entered into on or after 20 May 1999 and—

(a) the lease is a consecutive or a successive lease—

(i) that is treated as 1 lease under the definition of **lease**; and

(ii) with a term of the lease that the lessor and lessee do not contemplate, at the start of the term, will be more than 75% of the personal property lease asset's estimated useful life; and

(iii) with a term of the lease that is more than 75% of the asset's estimated useful life:

(b) the lease is an operating lease that becomes a finance lease under paragraph (c) of the definition of **finance lease**.

Adjustment required

(2) The lessor and lessee must each adjust their income and expenditure calculated for the lease by including an adjustment in a return of income for the tax year corresponding to the income year in which the lease becomes a finance lease.

Amount of adjustment

(3) The amount of the adjustment is calculated for the relevant person in relation to the period described in subsection (5) using the formula—

finance income − finance expenditure − unadjusted income + unadjusted expenditure.

Definition of items in formula

(4) In the formula,—

(a) **finance income** is the income that would have been derived by the person under the lease if the lease were a finance lease for the period:

(b) **finance expenditure** is the expenditure that would have been incurred by the person under the lease if the lease were a finance lease for the period:

(c) **unadjusted income** is the income derived by the person under the lease:

(d) **unadjusted expenditure** is the expenditure incurred by the person under the lease.

Adjustment period

(5) The period starts on the date on which the lease starts and ends on the last day of the income year in which the lease becomes a finance lease.

Adjustment positive

(6) If the adjustment is positive, the amount is income of the relevant person under section CH 6 (Adjustments for certain finance and operating leases).

Adjustment negative

(7) If the adjustment is negative, the amount is a deduction of the relevant person under section DB 51B (Adjustments for leases that become finance leases).

FA 11B Adjustments for certain operating leases

When this section applies

(1) This section applies when a lease is an operating lease that—

(a) is entered into on or after 20 May 1999 and before 20 June 2007; and

(b) is an arrangement, or part of an arrangement that, on 20 June 2007, meets the requirements of paragraph (c)(i) to (iii) of the definition of **finance lease**; and

(c) has a term of the lease ending after the end of the income year in which 20 June 2007 falls (the **adjustment year**); and

(d) does not meet the requirements of section FA 11(1) before the end of the income year after the adjustment year.

Adjustment required

(2) The lessor must adjust their income and expenditure calculated for the lease asset by including an adjustment in a return of income for the tax year corresponding to the income year after the adjustment year.

Amount of adjustment

(3) The amount of the adjustment is calculated using the formula—

total depreciation losses ÷ 6

Definition of item in formula

(4) In the formula, **total depreciation losses** is the total amount of depreciation loss for the lease asset for which the lessor is allowed a deduction in the period that begins with the start of the term of the lease and ends with the end of the adjustment year.

INTERPRETATION STATEMENTS

Income

(5) The amount of the adjustment is income of the lessor under the lease under section CH 6 (Adjustments for certain finance and operating leases) in the income year after the adjustment year.

Adjusted tax value

(6) The adjusted tax value of the lease asset at the beginning of the income year after the adjustment year is the total of the amount of the adjustment and the adjusted tax value that the lease asset would have in the absence of this section.

Depreciation loss

(7) For an income year beginning after 20 June 2007 in which the lease is an operating lease, the amount of depreciation loss allowed for the lease asset other than under section EE 48 (Effect of disposal or event) is five-sixths of the amount of depreciation loss that would be allowed for the lease asset in the absence of this subsection.

8. Schedule 14 states:

…

7 the copyright in software, the right to use the copyright in software, or the right to use software

…

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 17/03: Tax Administration Act 1994 - the period for which a private or product ruling applies

The binding rulings regime has operated for over 20 years. From time to time, the Commissioner will publish guidance about certain aspects of the regime that may be of wider interest.

Over the years, Inland Revenue has developed internal policies concerning the period a private or product ruling will be issued for. This item sets out the Commissioner's current practice on the period of the ruling, in the interests of informing ruling applicants and their agents. However, as a result of submissions received from public consultation on this item, the Commissioner will be recommending that issues regarding the period of a ruling (and whether there should be legislative change) be further considered as part of the broader changes to the binding rulings regime discussed in the recent discussion document *Making tax simpler – Proposals for modernising the Tax Administration Act* (December 2016).

All legislative references are to the Tax Administration Act 1994 unless otherwise stated.

This Question We've Been Asked is about ss 91EB(1)(b) and 91FB(1)(b).

Question

1. We have been asked what the Commissioner's practice is on the length of the term of a private or product ruling.

Answer

2. While the binding rulings legislation in Part 5A recognises that a private or product ruling must state the period for which the ruling applies, the legislation does not specify what that period should be. This is left to the discretion of the Commissioner. The Commissioner considers that when exercising this statutory power, the relevant factors that should be taken into account include (depending on the relevant circumstances):
   - the nature of the arrangement that is the subject of the ruling application;
   - the taxation laws on which the ruling is sought;
   - the desire to provide certainty to the applicant;
   - consistency and fairness as between different ruling applicants;
   - the fiscal risk to the Crown if the ruling is later found to understate the correct tax liability;
   - the degree of certainty as to the legal correctness of the decision; and
   - the likelihood or risk of the Commissioner's interpretation of the law changing over time.
3. In determining the period for which a ruling should apply, the Commissioner's practice has been along the following lines:
   a) Where an arrangement has a term or expected life of less than three years, such as a share repurchase that is planned on a particular day, the Commissioner will issue a ruling for a period that is the exact term or expected life of the arrangement. The Commissioner may, however, provide a ruling for a longer period if there is material uncertainty about either the date of implementation or the length of the term or expected life of the arrangement, in order to allow a reasonable period for the arrangement to be completed.
   b) Where an arrangement has a term or expected life of more than three years, the Commissioner will generally rule for a period of three years from the date of issue of the draft or final ruling. The Commissioner considers that a period of three years is a reasonable balance between the relevant matters set out above, particularly the desire to provide certainty to applicants and the risk of the Commissioner's interpretation changing over time.
   c) If the arrangement was entered into before the date of issue of the draft or final ruling, the Commissioner will generally add the time that has elapsed since the arrangement was entered into to the three-year period (to the extent reasonable and permitted by legislation).

d) The Commissioner will consider the applicant's circumstances in determining the period of the ruling. If there are particular features of the arrangement that would make ruling for a period of three years undesirable (for example, if the arrangement has a fixed life of three years and six months, or where the parties have agreed to renegotiate the terms of the arrangement after four years), the Commissioner may agree to extend the period beyond three years.

e) On a reissue of a ruling, where an arrangement has a remaining term or expected life of more than five years, the Commissioner will generally rule for a period of five years from the date the previous ruling ceased to apply, having regard to criteria such as:

- the added certainty for the taxpayer if the ruling applies for a longer period, particularly if the arrangement is likely to be on-going for a substantial time;
- whether the issues ruled on are likely to be affected by any new case law; and
- whether any of the issues are potentially contentious.

Otherwise, the reissue would be for a maximum of three years for on going arrangements.

f) Periods in excess of five years (for a new ruling or a reissue) will only be considered by the Commissioner in exceptional circumstances where, due to the special characteristics of the particular arrangement and the application of the taxation laws, a shorter period would not be sensible. This may include situations where:

- the taxation law will not apply until a date in the future that would be outside a three- or five-year period (for example, if the ruling is on the application of the base price adjustment formula (s EW 31 of the Income Tax Act 2007) and the financial arrangement is not expected to mature for 10 years); or
- the taxation law must be applied over the life of the arrangement and it would not be possible or sensible to try to reverse out the tax treatment after three or even five years, such as a ruling in relation to the spreading method that applies to a rental prepayment over the life of a 15-year lease.

In deciding whether to issue a ruling for a period in excess of five years, the Commissioner will take into account the same criteria that would be taken into account for a reissue. The value of the transaction or importance of the arrangement will not be a relevant factor.

In these exceptional circumstances, the Commissioner may be willing to rule for the whole term or expected life of the arrangement.

g) For a unilateral advanced pricing agreement (APA) that is issued in the form of a private ruling, the period of the ruling (for either a new APA or a reissue) will usually be five years. However, depending on the economic circumstances of the particular case, such as the relevant business cycle of the industry concerned, an APA may be issued for a longer period if agreed between the applicant and Service Delivery.

Explanation

4. The binding rulings regime was introduced in 1995 to give taxpayers greater certainty regarding the Commissioner's view of the tax implications of transactions and arrangements. A private ruling gives the Commissioner's interpretation of the tax law as it applies to a specific taxpayer and a particular arrangement. A product ruling gives the Commissioner's interpretation of the tax law as it applies to a particular "product" (where it is not practicable to identify the taxpayers who may enter into the arrangement). The Commissioner is required to apply the tax treatment prescribed in a private or product ruling for the duration of the ruling.

5. The binding rulings legislation (ss 91EB(1)(b) and 91FB(1)(b)) provides that a private or product ruling will apply "only for the period or tax year for which the ruling applies". Sections 91EH(1)(d) and 91FH(1)(e) provide that a private ruling or product ruling must state the "period or tax year for which the ruling applies". The term "tax year" is defined in s YA 1 of the Income Tax Act 2007 as "a period starting on 1 April and ending on 31 March".

6. The effect of these provisions is that the Commissioner is able to issue a private or product ruling that applies for either a particular "tax year" or for a specific "period".

7. However, other than the reference to a "tax year", the legislation does not specify the period a ruling should be issued for. The legislation does not, for example, set out any minimum or maximum periods for which a ruling can apply. As there is no legislative guidance on this issue, the Commissioner must decide what the appropriate period will be for each private or product ruling issued. This is a matter of reasonable administrative practice.

8. Where a private or product ruling applies, and has not ceased to apply under ss 91EB(2) or 91FB(2), the Commissioner is legally bound to apply the specified taxation law in the specified way for the period of the ruling if the taxpayer applies the law as stated in the ruling (ss 91EA(1) and 91FA(1)). The only exception to this is where the taxpayer has issued the

Commissioner with a notice of proposed adjustment to change the effect of a ruling previously applied by the taxpayer (ss 91EA(1A) and 91FA(1A)). This provides the taxpayer with certainty against changes in the Commissioner's interpretation of the tax law during the relevant period.

9. However, there is a fiscal risk to the Crown that an applicant's correct tax liability may be understated if the interpretation of the taxation law and how it applies to the arrangement is later found to be incorrect. This potential risk was recognised by the Government prior to the introduction of the binding rulings regime (in *Binding Rulings on Taxation (A discussion document on the proposed regime)* (Government discussion document, June 1994) (the Discussion Document)).

10. To minimise this risk, the Commissioner is not generally prepared to issue binding private or product rulings for an extended period. The Discussion Document noted that it was not intended that a private ruling would apply for an unspecified period as changing circumstances over time would make such an approach inappropriate. Issuing a binding ruling for a limited time allows the Commissioner to review any developments of the law and consider any implications for the ruling within a reasonable time frame.

11. When determining the appropriate period for which the Commissioner will issue a ruling, a balance must therefore be struck between a number of factors, including fairness to the applicant (who has invested time and money in applying for the ruling) and the appropriate level of risk if an incorrect or deficient ruling is issued for an extended period of time.

12. When deciding the appropriate period for a private or product ruling, the Commissioner will first consider the arrangement and the period requested by the applicant in their application. As noted in [2] above, the Commissioner will also take into account other factors, such as:

- the nature of the arrangement that is the subject of the ruling application;
- the taxation laws on which the ruling is sought;
- the desire to provide certainty to the applicant;
- consistency and fairness as between different ruling applicants;
- the fiscal risk to the Crown if the ruling is later found to understate the correct tax liability;
- the degree of certainty as to the legal correctness of the decision; and
- the likelihood or risk of the Commissioner's interpretation of the law changing over time.

References

Subject references

Period of the ruling

Legislative references

Tax Administration Act 1994, ss 91EA, 91EB, 91EH, 91FA, 91FB and 91FH

Income Tax Act 2007, definition of "tax year" in s YA 1

Other references

Binding Rulings on Taxation (A discussion document on the proposed regime) (Government discussion document, June 1994)

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

Determination DET 09/02: Standard-cost household service for childcare providers

In accordance with the provisions of Determination DET 09/02, as published in *Tax Information Bulletin* Volume 21, Number 4 (June 2009), Inland Revenue advises that, for the 2017 income year:

(a) The variable standard-cost component will be $3.51 per hour per child; and

(b) The administration and record keeping fixed standard-cost component will be $343 per annum, for a full 52 weeks of childcare services provided.

The above amounts have been adjusted as a consequence of the annual movement of the Consumers Price Index for the twelve months to March 2017, which showed an increase of 2.2%. For childcare providers who have a standard 31 March balance date, the new amounts apply for the period from 1 April 2016 to 31 March 2017.

Determination DET-05/03: Standard-cost household service for boarding service providers

In accordance with the provisions of Determination DET-05/03, as published in *Tax Information Bulletin* Vol 17, No 10 (December 2005), Inland Revenue advises that, for the 2017 income year:

(a) The weekly variable standard-cost for one to two boarders will be $263 each; and

(b) The weekly variable standard-cost for third and subsequent number of boarders will be $215 each.

The above amounts have been adjusted as a consequence of the annual movement of the Consumers Price Index for the twelve months to March 2017, which showed an increase of 2.2%. For boarding service providers who have a standard 31 March balance date, the new amounts apply for the period from 1 April 2016 to 31 March 2017.

2017 review of the Commissioner's mileage rate for expenditure incurred for the business use of a motor vehicle

Operational Statement 09/01 ("OS") published in the *Tax Information Bulletin* Volume 21, Number 3 (May 2009) provides the Commissioner's statement of a mileage rate for expenditure incurred for the business use of a motor vehicle (OS 09/01 can be viewed at the Inland Revenue website **www.ird.govt.nz/technical-tax/op-statements/**). This OS provides that the Commissioner will review mileage rate on a yearly basis.

A review of the Commissioner's mileage rate results in an increased rate of 73 cents per kilometre for both petrol and diesel fuel vehicles for the 2017 income year compared to 72 cents for the 2016 income year. The increase is primarily due to a slight increase in fixed vehicle costs and higher average fuel costs during the 2017 income year. The 2017 income year for business taxpayers with a standard 31 March balance date, runs from 1 April 2016 to 31 March 2017.

This year we are also able to set mileage rates for hybrid and electric cars. For the first time we have been able to obtain reliable data in respect of the fixed and running cost for these types of vehicles. These mileage rates are:

Hybrid – 73 cents per km

Electric – 81 cents per km

For both Hybrid and Electric vehicles, our data shows that although these types of vehicle have lower running costs, these are offset by higher fixed costs.

The Commissioner is required to set a mileage rate for persons whose business travel is 5,000 km or less in an income year. The mileage rate is set retrospectively for persons required to file a return for business income, so that the rate reflects the average motor vehicle operating costs for an income year. Those persons who meet the criteria have a choice of using the mileage rate method or they may use actual costs if they consider that the Commissioner's mileage rate does not reflect their true costs. Taxpayers that choose to use actual costs are required to keep records to support any expenditure claimed.

The Commissioner does not propose to amend the returns for taxpayers who have already filed their 2017 returns using the 2016 mileage rate.

The Commissioner accepts that employers may use the 2017 vehicle mileage rate as a reasonable estimate of costs when they reimburse employees for the use of their private vehicle for business related travel for a current income year (post 1 April 2017).

Also, employers may use an alternative estimate other than the Commissioner's vehicle mileage rate when reimbursing employees for use of their private vehicle for employment related use. It is accepted that employers may use the motor vehicle running cost data published by other reputable sources, for example the New Zealand Automobile Association Incorporated, as an alternative reasonable estimate for reimbursement of employees.

The mileage rate does not apply in respect of motor cycles as this mode of transport is not commonly used for business purposes. Any self-employed persons who use this form of transport for business purposes will need to calculate their actual expenditure or in the situation of an employer reimbursement, they may make a reasonable estimate of the employee's costs.

As a consequence of changes to the legislation, effective from the 2018 income year, a draft replacement OS will be released for consultation at some future stage.

Approved for publication

LTS Manager Technical Standards

4 May 2017

National average market values of specified livestock determination 2017

Note to this determination

This note does not form part of the national average market values of specified livestock determination 2017 (the determination) but are produced to aid Inland Revenue staff, taxpayers and their agents in their understanding of how the values contained in this determination are arrived at and how they should be used.

Section EC 15 of the Income Tax Act 2007 (the Act) requires the Commissioner of Inland Revenue (CIR) to make a determination declaring the national average market values (NAMV) of certain types and classes of livestock. This determination is published in May each year.

These NAMVs are used by livestock owners to value their livestock on hand where owners have elected to use the herd scheme to value livestock in an income year.

As the name of this determination suggests, NAMVs provide the national average market value of specified livestock classes. As such they may not always reflect the market value of the livestock of a particular taxpayer, or of a particular region. This being so, the values are not intended to be used for any other purpose than that for which they are produced; valuing livestock of taxpayers who have elected to value their livestock under the herd scheme in the income year for which the determination relates.

In order to ascertain the market value of the various classes of livestock the CIR contracts with a number of experienced livestock valuers situated throughout the country[1]. Each valuer is asked to provide the market value of the various specified livestock classes located in their region. There is generally more than one valuer contracted for each region. The market

[1] 38 valuations were obtained for the 2017 determination.

valuations required are for "good quality on-farm animals" as at 30 April. From these values the CIR then calculates the national average market value for each livestock class. In the case of sheep, beef, dairy cattle and deer classes a weighted average is used (based on total livestock numbers for a type of livestock in that region compared to the national herd numbers for that type of livestock[2]). Because of the comparatively low numbers of livestock, a straight average is used for the remaining livestock types.

National Average Market Values of Specified Livestock Determination 2017

This determination may be cited as "The National Average Market Values of Specified Livestock Determination, 2017".

This determination is made in terms of section EC 15 of the Income Tax Act 2007 and shall apply to specified livestock on hand at the end of the 2016-2017 income year.

For the purposes of section EC 15 of the Income Tax Act 2007 the national average market values of specified livestock, for the 2016-2017 income year, are as set out in the following table.

Type of livestock	Class of livestock	Average Market Value per Head $
Sheep		
	Ewe hoggets	109.00
	Ram and wether hoggets	103.00
	Two-tooth ewes	150.00
	Mixed-age ewes (rising three-year and four-year old ewes)	131.00
	Rising five-year and older ewes	110.00
	Mixed-age wethers	86.00
	Breeding rams	349.00
Beef Cattle	***Beef breeds and beef crosses:***	
	Rising one-year heifers	824.00
	Rising two-year heifers	1171.00
	Mixed-age cows	1431.00
	Rising one-year steers and bulls	986.00
	Rising two-year steers and bulls	1325.00
	Rising three-year and older steers and bulls	1614.00
	Breeding bulls	3095.00
Dairy Cattle	***Friesian and related breeds, Jersey and other dairy breeds:***	
	Rising one-year heifers	819.00
	Rising two-year heifers	1421.00
	Mixed-age cows	1649.00
	Rising one-year steers and bulls	713.00
	Rising two-year steers and bulls	1091.00
	Rising three-year and older steers and bulls	1356.00
	Breeding bulls	1887.00
Deer	***Red deer, wapiti, elk, and related crossbreeds:***	
	Rising one-year hinds	303.00
	Rising two-year hinds	473.00
	Mixed-age hinds	526.00
	Rising one-year stags	343.00
	Rising two-year and older stags (non-breeding)	595.00
	Breeding stags	1861.00

[2] Numbers are based on data collated by Statistics New Zealand.

Type of livestock	Class of livestock	Average Market Value per Head $
Deer (continued)	***Other breeds:***	
	Rising one-year hinds	200.00
	Rising two-year hinds	331.00
	Mixed-age hinds	375.00
	Rising one-year stags	262.00
	Rising two-year and older stags (non-breeding)	425.00
	Breeding stags	708.00
Goats	***Angora and angora crosses (mohair producing):***	
	Rising one-year does	39.00
	Mixed-age does	59.00
	Rising one-year bucks (non-breeding)/wethers	42.00
	Bucks (non-breeding)/wethers over one year	42.00
	Breeding bucks	343.00
	Other fibre and meat producing goats (Cashmere or Cashgora producing):	
	Rising one-year does	33.00
	Mixed-age does	42.00
	Rising one-year bucks (non-breeding)/wethers	42.00
	Bucks (non-breeding)/wethers over one year	51.00
	Breeding bucks	345.00
	Milking (dairy) goats:	
	Rising one-year does	320.00
	Does over one year	400.00
	Breeding bucks	270.00
	Other dairy goats	20.00
Pigs		
	Breeding sows less than one year of age	263.00
	Breeding sows over one year	365.00
	Breeding boars	314.00
	Weaners less than 10 weeks of age (excluding sucklings)	75.00
	Growing pigs 10 to 17 weeks of age (porkers and baconers)	143.00
	Growing pigs over 17 weeks of age (baconers)	203.00

This determination is signed by me on the 17th day of May 2017.

Vanessa Montgomery
LTS Manager
Technical Standards

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

Chatfield & Co Limited v Commissioner of Inland Revenue: Discovery in the Context of Judicial Review

Case	Chatfield & Co Limited v Commissioner of Inland Revenue [2017] NZSC 48
Decision date	11 April 2017
Act(s)	N/A
Keywords	Leave to appeal, discovery, double taxation agreement

Summary

The Commissioner of Inland Revenue ("the Commissioner") issued a number of Notices under s 17 of the Tax Administration Act 1994 ("the TAA") to the appellant. The appellant sought to judicially review this, and as part of that sought discovery of certain material ("the Documents"). The High Court refused this request, and that was upheld on appeal by the Court of Appeal. The appellant then sought leave to appeal to the Supreme Court. The Supreme Court refused leave on the basis that the issue here was straightforward, and was a matter of the application of settled principles to a particular fact situation. It was not necessary for the Supreme Court to engage with this issue.

Impact

The appellant has now exhausted its appeal rights in regards to its request for discovery of the Documents. The High Court's decision to refuse discovery is upheld and the Commissioner will not be required to provide the Documents. The decision has limited wider impact, as it is largely limited to its particular facts, although may provide some guidance on the Supreme Court's approach to determining applications for leave to appeal in the discovery context.

Facts

The Appellant appealed against a decision of the High Court declining an application for discovery of the Documents exchanged pursuant to the Double Taxation Agreement between New Zealand and the Republic of Korea ("the DTA").

The decision of the High Court was reflected by judgments of Ellis J dated 1 September 2015 (*Chatfield & Co Ltd v Commissioner of Inland Revenue* [2015] NZHC 2099, (2015) 27 NZTC 22-024) and 9 June 2016 (*Chatfield & Co Ltd v Commissioner of Inland Revenue* [2016] NZHC 1234, (2016) 27 NZTC 22-053).

The Appellant's substantive litigation originally involved two causes of action. The first was that the Appellant had a legitimate expectation under an operational statement known as OS 13/02 (*Operational Statement: Section 17 notices* (Inland Revenue, OS 13/02, 14 August 2013)). The second was that the Commissioner failed to consider the terms of OS 13/02, the limited nature of the tax agent/client relationship and the terms of the DTA between New Zealand and the Republic of Korea. The first cause of action and the first two limbs of the second cause of action were struck out by judgment of Lang J dated 27 September 2016 (*Chatfield & Co Ltd v Commissioner of Inland Revenue (No 2)* [2016] NZHC 2289, (2016) 27 NZTC 22-072).

This left the allegation that in making the decision to issue the s 17 notices the Commissioner failed to consider the terms of the DTA as the last remaining cause of action.

In the High Court Ellis J concluded that the only aspect of the pleading to which the documents would relate (namely the allegation that the Commissioner failed to take into account the DTA) was unlikely to be justiciable and the Documents were confidential and not required to be disclosed (*Chatfield & Co Ltd v Commissioner of Inland Revenue* [2016] NZHC 1234, (2016) 27 NZTC 22-053 at [22]).

The Court of Appeal agreed with the High Court that the documents were not required to be disclosed, noting that discovery in judicial review proceedings is not available as of right. The power of the Court to grant discovery in judicial review proceedings is discretionary and contrasts with the position in an ordinary proceeding.

The Court of Appeal considered the Commissioner had considered the relevant terms of the DTA and characterised the application for discovery as effectively a "fishing" expedition. As a result the Court of Appeal dismissed the appeal.

The appellant then sought leave to appeal to the Supreme Court.

Decision

The Supreme Court declined the application for leave and awarded costs of $2,500 to the Commissioner.

In reaching its decision the Supreme Court noted that while the applicant raised issues of a type that would warrant the Court's attention, the issue was straightforward on the particular circumstances of this case because:

1. The Court had discretion as to whether or not to order discovery.
2. The Court had to consider whether the materials sought were relevant given the only remaining live issue.
3. The Court concluded on the pleadings that they were not.

The Supreme Court noted this was simply a matter of applying settled principles to a particular fact situation and not a matter which it was necessary for the Supreme Court to engage in.

TRA upholds Commissioner's reassessments for undisclosed income

Case	TRA 023/15 [2017] NZTRA 02
Decision date	28 March 2017
Act(s)	Tax Administration Act 1994: ss 141C and 149A
Keywords	"Undisclosed income", "asset accretion method" and "credibility"

Summary

The Commissioner of Inland Revenue ("the Commissioner") reassessed the taxpayer for undisclosed income and imposed gross carelessness shortfall penalties. The taxpayer challenged the reassessments claiming that the money had come from various sources, including the sale of gold Krugerrand coins and an interest free loan from her uncle in China. The Taxation Review Authority ("the Authority") found the taxpayer's explanations to not be credible, and consequently upheld the Commissioner's reassessments.

Impact

The decision reiterates the fundamental principles applying to the Commissioner when making amended assessments, and is an example of the appropriate use of the asset accretion method.

Facts

The Commissioner reassessed the disputant for undisclosed income in the tax years ended 31 March 2005 to 31 March 2011, and imposed shortfall penalties for gross carelessness or in the alternative, for failing to take reasonable care. The disputant challenged the reassessments and imposition of shortfall penalties.

The disputant first came to the Commissioner's attention during an audit of the X Restaurant ("the restaurant"). The disputant had been employed at the restaurant as a waitress and at times, acting manager since 1996. As part of the restaurant's audit, the Commissioner checked bank statements of a small sample of its employees including the disputant's. The bank statements of the disputant recorded a high frequency of large deposits and withdrawals over a number of years. Notably, a substantial number of the deposits were made in cash, and in 2008, the disputant had purchased a house mortgage free for $405,000.

On 1 February 2012, the disputant filed income tax returns for the 2000 to 2011 tax years. The returns disclosed that the disputant had earned income from the following sources: (a) wages from the restaurant; (b) interest on her New Zealand bank accounts and term deposits; and (c) overseas income consisting of interest earned on a bank account in Australia. Following receipt of these tax returns, the Commissioner commenced an audit into the disputant's tax affairs.

The disputant claimed that her money had come from several sources (apart from the income which she had declared) including: (1) the sale of gold Krugerrands coins which had been given to the disputant by her grandparents in China; and (2) an interest free loan of NZ$286,000 from her uncle in China. The disputant also alleged that the funds deposited in her Australian account and on which she had declared the interest earned, were funds belonging to her parents.

The Commissioner maintained that the disputant's explanations for her increase in assets were not credible, and accordingly reassessed the disputant for undisclosed income.

Decision

Sale of Krugerrands

The disputant claimed that she had been gifted a number of gold Krugerrand coins, which she had brought to New Zealand and sold. During cross-examination the disputant changed her evidence as to when she brought the coins to New Zealand. The disputant told the Authority that she sold the coins to tourists dining at the restaurant. The amounts she said were paid for the coins greatly exceeded the spot price of gold in the period (expert evidence was provided by a gold trader and investor).

The Authority held that overall it did not find the disputant to be a reliable or credible witness and held her answers to be often vague and inconsistent.

The Authority found it was implausible that over a period of six years, the disputant had sold 73 Krugerrands to Asian tourists at the restaurant for sums very considerably above the spot price of gold at the time.

Accordingly, the Authority did not accept the disputant's explanation that one of the sources of her money was the sale of Krugerrands at the restaurant.

Loan from Uncle

The disputant gave evidence that in 1999 on a visit back to China she and her uncle Mr SP entered into an agreement for an interest free loan of RMB1,250,000 ("the Loan Agreement"). The Loan Agreement provided for the money to be used by the disputant to purchase a house, and the disputant gave evidence that this house was to be used by Mr SP's children when they came to New Zealand to study. Under the Loan Agreement the disputant was to pay the children's education and living expenses and deduct these sums from the loan amount.

Mr SP gave evidence by video link from China. Under cross-examination Mr SP initially conceded that the Loan Agreement was not signed in 1999 and volunteered that it had been signed "just because of the tax department matter". However, following further questioning he changed his evidence to say that he could not remember when it was signed. The Authority held it was satisfied the Loan Agreement was prepared and signed after the Inland Revenue investigation commenced.

Overall, the Authority found the evidence of both the disputant and her uncle to be unconvincing. The Authority noted that it was plain the disputant had received large amounts of money over the years and the onus was on her to satisfy the Authority as to its source. The Authority was not satisfied that there was a loan agreement between the disputant and her uncle, and accordingly did not accept the disputant's explanation that a source of her funds was money advanced under this alleged agreement.

Australian Bank Account

Evidence was given by the disputant and her father Mr XD in relation to the money in the disputant's Australian bank account. The disputant contended that the funds paid into the account belonged to her elderly parents.

The disputant told the Authority that when her parents first moved to Australia they would withdraw their pension payments, and keep the money at home as they did not trust banks. On one of the disputant's visits to Australia it was decided that she would manage her parents' money; she opened an account in her own name and her parents' savings were deposited into that account.

The Commissioner produced evidence from the Australian Taxation Office detailing Mr XD and his wife's pension payments. The received payments differed from those used by Mr XD in his own calculations, and were significantly less than the total amounts deposited into the disputant's account.

The Authority agreed with the Commissioner that it could properly be inferred that the deposits paid into the account by the disputant on her visits to Sydney were not sourced from her parents' income and were income of the disputant.

Reassessments

The investigator for the Commissioner gave evidence that because it appeared that the disputant's income and expenses were mostly in cash, she formed the view that the disputant's income could not be assessed by simply looking at the deposits made into her account. The investigator therefore decided to use the asset accretion method.

The Authority found that, in the circumstances of the case, the Commissioner was justified in reassessing the disputant for undisclosed income using the asset accretion method.

Shortfall penalties

The Authority held that any reasonable person in the disputant's position would have foreseen that their failure to disclose income would create a high risk of a tax shortfall. Accordingly, the Authority held that the imposition of gross carelessness penalties was appropriate.

Decision

The Authority upheld the Commissioner's reassessments and imposition of shortfall penalties for gross carelessness.

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy and Strategy

Policy advises the Government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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